

TAX REFORM: REMOVING BARRIERS TO SMALL BUSINESS GROWTH

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP UNITED STATES SENATE

ONE HUNDRED FIFTEENTH CONGRESS

FIRST SESSION

JUNE 14, 2017

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TAX REFORM: REMOVING BARRIERS TO SMALL BUSINESS GROWTH

WEDNESDAY, JUNE 14, 2017

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS
AND ENTREPRENEURSHIP,
Washington, DC.

The Committee met, pursuant to notice, at 3:04 p.m., in Room 428A, Russell Senate Office Building, Hon. James Risch, Chairman of the Committee, presiding.

Present: Senators Risch, Ernst, Inhofe, Young, Kennedy, Shaheen, Cantwell, Heitkamp, Booker, and Duckworth.

OPENING STATEMENT OF HON. JAMES E. RISCH, CHAIRMAN, AND A U.S. SENATOR FROM IDAHO

Chairman RISCH. Well, this meeting now will come to order, and welcome, everyone, this afternoon, and thank you so much for coming.

Before we get started I would like to recognize that—and I speak for both myself, I am sure the Ranking Member also, that our thoughts and prayers are with our colleagues who were injured in this morning's horrific attack, as well as with the heroic Capitol Police officers who sustained injuries as they took the necessary measures to protect our colleagues and the public. I have had an opportunity to talk to our colleagues from the Senate who were there, and they said if it was not for the Capitol Police this thing would have been much, much worse than what it was. So our thoughts and our prayers go out to all who were involved and to their families.

With that, again, I would like to welcome everyone to our hearing today, and we are going to talk about tax reform, removing the barriers to small business growth. Myself, and I know the Ranking Member, likewise, has been in government virtually all of our adult lives, and have dealt with business, both small and big business, from both sides, and as a result of that we have come to understand the many, many challenges that face small businesses in America today.

Small business owners want to spend their time growing their businesses and not taking time away from that effort to figure how to comply with the tax code and, more often than not, hiring outside tax help to make sure they are doing what they are supposed to do.

Here is what we know. Tax compliance costs are 67 percent higher for small businesses than they are for big businesses, and rough-

ly 89 percent of small owners have to rely on outside tax preparers. Small businesses spend a lot of time and money that could be spent on their businesses trying to understand and comply with the law. If Congress is going to take a serious look at reforming the tax code, we certainly should look at ways it can be simplified, and how compliance costs can be decreased, and permanency provided so that small business owners know what rules they are playing by, and can do so with decreased cost to their business and, obviously, more productivity.

Another significant issue for small businesses is whether tax reform will reduce rates for pass-through entities. Today, more than 90 percent of businesses are considered sole proprietorships, or pass-through entities, while more than half of business income in the United States is earned through small businesses identified as one of these types of businesses.

When we look at these numbers it is clear that if we want tax reform to bring growth to our economy, we must look at the individual tax code under which pass-through entities are taxed. We have to ensure that the reforms that could provide the most small business growth do not get lost in the discussion about tax reform, and that is one of the reasons why we are here today, and both the Ranking Member and I are absolutely committed to see that we hold the people's feet to the fire that are going to be working on tax reform.

I would like to introduce two of the witnesses and then I am going to yield to Senator Shaheen.

I would like to welcome Ms. Annette Nellen, the Chair of the American Institute of CPAs Tax Executive Committee. This committee is the most senior committee of the tax division of the organization, and speaks for them on all matters related to taxation, including tax policy and legislation. She is also a professor at San Jose State University, where she teaches a number of tax-related courses and directs the graduate tax program. Ms. Nellen is a CPA herself, and will bring a wealth of knowledge and expertise to our discussions about the compliance issues small businesses face with our current tax system, and we are pleased to have her here today.

I am also pleased to welcome Mr. Brian Reardon, President of the S Corporation Association. Mr. Reardon has, through his position with the association, a long history of advocating for 4.6 million S corporations across the country, to make sure their voices are heard when it comes to tax issues, and the implications of government mandates for small businesses. He will be able to provide the voice of small businesses across the country, across industry, of varying sizes, when it comes to the difficulties they have with the current tax system.

I also wanted to recognize Mr. Mazur, the Director of the Urban-Brookings Tax Policy Center, who will be further introduced by Ranking Member Shaheen.

Thank you all, again, for coming here today to join us on this important hearing, and with that, I want to turn the time over to our Ranking Member, Senator Shaheen.

**OPENING STATEMENT OF HON. JEANNE SHAHEEN, RANKING
MEMBER, AND A U.S. SENATOR FROM NEW HAMPSHIRE**

Senator SHAHEEN. Thank you very much, Mr. Chairman. This is an important hearing as we look at how we can remove burdens of our tax code on small business. As we all know, our tax code is in desperate need of reform. It is too long, too complex, and it creates a burden on middle-class families and small businesses across this country. Today's hearing is an important opportunity for us to discuss how we might relieve some of these tax burdens on small businesses.

As I travel around New Hampshire, and talk to small business owners, what I hear is that they are concerned about the red tape, mostly related to our tax code. According to the National Taxpayer Advocate Service, small businesses spend 2.5 billion, with a B, hours complying with the IRS rules each year, and, of course, for entrepreneurs, time is one of their most valuable resources, so every hour spent filling out forms is an hour they do not have to think about growing their businesses.

So as we consider tax reform, we need to put the needs of small businesses front and center. We can do that, I think, by taking some common-sense steps to simplify taxes for small businesses, to relieve the burden that the tax code places on them, and we should look at closing loopholes that allow large businesses to avoid paying their fair share of taxes. We must ensure that our tax code is up to date, so that it encourages economic growth and competitiveness in emerging sectors of our economy.

A lot has changed in the last 30 years since we last updated the tax code. As Congress considers tax reform, we need to make sure that our 29 million small businesses have a seat at the table, and so that is why we are looking forward to hearing from our witnesses today. We thank you for being here.

And I will just point out that Mr. Mazur, who is Director of the Urban-Brookings Tax Policy Center is the Director of that center. From 2012 until 2017, he was the Assistant Secretary for Tax Policy at the U.S. Department of the Treasury, and he has served in the Federal Government for 27 years in various positions that relate, in some way, to our economy and to our tax code. So we are delighted to have you here and look forward to hearing your testimony.

Thank you all, very much.

Chairman RISCH. Thank you. What we would—I am going to recognize each of you to make an opening statement, if you would, please. Please try to keep it to about five minutes. Obviously, any remarks that you have we will accept for the record and publish it in the record of these proceedings. The members are anxious to get to questions that they want to drill down on, so with that, Ms. Nellen, we will recognize you first.

**TESTIMONY OF ANNETTE NELLEN, CHAIR, AICPA TAX
EXECUTIVE COMMITTEE**

Ms. NELLEN. Thank you. Chairman Risch, Ranking Member Shaheen, and members of the Senate Committee on Small Business and Entrepreneurship, thank you for the opportunity to testify. The AICPA appreciates your leadership in ensuring that tax reform

considers ways to reduce the burden and complexity of tax compliance for small businesses and how that burden can hinder business growth.

Today I would like to highlight a few tax reform issues that directly impact small businesses and their owners. First, tax relief should not mean a rate reduction for C corporations only. Congress should continue to encourage, or at least not discourage, the formation of sole proprietorships and pass-through entities. If Congress decides to lower corporate income tax rates, small businesses should receive a lower tax rate as well.

We recognize that providing a reduced rate for income of small businesses will place additional pressure on the need to distinguish between profits of the business and compensation of the owner-operators. We should continue to use traditional definitions of reasonable compensation for this purpose. Partnerships and sole proprietorships should be required to charge reasonable compensation. We should not treat partners and sole proprietors as employees but rather as owner-operators whose labor is subject to appropriate withholding taxes.

If Congress decides to use a 70/30 rule, treating 70 percent of pass-through income as employment income and 30 percent as return on capital, we urge you to make this proposal a safe harbor, rather than a hard and fast rule. A safe harbor would promote simplicity for many businesses without sacrificing fairness for others. To minimize controversy, the IRS should take additional steps to improve compliance in this area. Reporting requirements to disclose the factors considered and determining compensation would help address the enforcement challenges currently faced by the IRS. These new reporting requirements would only apply to owner-operators who believe their particular situation warrants treating a higher percentage of pass-through income as active business income than is allowed under the safe harbor.

Next, we are concerned with, and urge you, to oppose any new limitations on the use of the cash method of accounting. The cash method is simpler in application, has fewer compliance costs, and does not require taxpayers to pay tax before receiving their income, which is why entrepreneurs often choose the cash method. Forcing more businesses to use the accrual method unnecessarily discourages business growth, increases compliance costs, and imposes financial hardship on cash-strapped businesses.

Another important issue is the ability to deduct interest expense. Owners borrow to fund operations, working capital needs, equipment acquisition, and even to build credit for future loans. We should not take away or limit this critical deduction for many small businesses who with little or no access to equity capital are often forced to rely on debt financing.

Another issue involves taxation of compensation. Congress should not reduce an employer's ability to deduct a compensation pay to its employees, whether in the form of wages or fringe benefits. At the same time, it is important to retain the employee fringe benefit exclusion. Changes in this area would impact the ability of small businesses to attract and return a competitive workforce.

Just quickly, a few additional items include increasing the start-up business deduction to give entrepreneurs the support they need

in the early years, simplifying laws for qualified retirement plans, and simplifying the penalty system. Also, the AMT should be repealed for individuals and corporations, thereby making the system simpler and more transparent.

Small business owners must deal with many business decisions and concerns. They have expertise in their business product and services but rarely are they experts in the areas of capitalization, retirement plan rules, and alternative income tax regimes.

Improvement of IRS services would also help small businesses. We recommend modernizing IRS business practices and technology. For example, a new executive-level practitioner services unit that includes an online tax professional account with access to client information should be created. Enhancing the relationship between the IRS and practitioners benefits both the IRS and the millions of taxpayers, including small businesses, served by the practitioner community.

Finally, we encourage you to enact mobile workforce legislation such as S. 540, introduced by Senator Thune. The burden of tracking and complying with all the different State payroll tax laws is complex and costly, particularly for small employers. S. 540 provides a uniform national rule for non-resident State income tax withholding, and a de minimis exemption from State income tax for non-resident employees.

We provide more details on our tax reform ideas in our written testimony. Thank you. I would be happy to answer your questions. [The prepared statement of Ms. Nellen follows:]



WRITTEN STATEMENT OF ANNETTE NELLEN
ON BEHALF OF THE
THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
BEFORE
THE UNITED STATES SENATE
COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
HEARING ON
TAX REFORM: REMOVING BARRIERS TO SMALL BUSINESS GROWTH
JUNE 14, 2017

AICPA's Written Statement of Annette Nellen, Chair, AICPA Tax Executive Committee
 U.S. Senate Committee on Small Business & Entrepreneurship
 June 14, 2017 Hearing on "Tax Reform: Removing Barriers to Small Business Growth"
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INTRODUCTION

Chairman Risch, Ranking Member Shaheen, and Members of the Senate Committee on Small Business & Entrepreneurship, thank you for the opportunity to testify today at the hearing on "Tax Reform: Removing Barriers to Small Business Growth." My name is Annette Nellen. I am a professor and director of San José State University's graduate tax program, teaching courses in tax policy and reform, tax research, accounting methods, property transactions, employment tax, leadership and ethics. I am the Chair of the Tax Executive Committee of the American Institute of CPAs (AICPA). I am pleased to testify today on behalf of the AICPA.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state, local and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We applaud the leadership taken by the Committee to consider ways to reduce the burden and complexity of tax compliance faced by small businesses to ensure that tax rules support rather than discourage growth of businesses, particularly small business. Small businesses are the backbone of the U.S. economy, accounting for 54% of all U.S. sales and providing 55% of all jobs.¹

Unfortunately, federal tax laws hinder growth for both small businesses and the U.S. economy. The increased time and effort needed to comply with the ever changing tax laws forces small businesses to devote extra time and dollars to tax compliance instead of growing their businesses. Time spent learning and complying with current tax laws often does not save time in future years as rules and tax compliance may change. According to a National Taxpayers Union Foundation study, the U.S. economy loses \$233.8 billion annually from dedicating 6.1 billion hours complying with tax laws.²

Of course, we recognize that tax compliance is necessary. To help small businesses grow, we offer suggestions where Congress and the Internal Revenue Service (IRS) can help reduce the compliance burden, increase transparency and provide certainty.

GOOD TAX POLICY

First, we should consider the features of an ideal tax system for small businesses. The AICPA urges the Committee to consider comprehensive tax reform that focuses on simplification and

¹ U.S. Small Business Administration, Small Business Trends, "Small Business, Big Impact!"

² National Taxpayers Union Foundation, Study: \$233.8 Billion, 6.1 Billion Hours Lost to Rising Tax Complexity, April 8, 2015. Also see IRS National Taxpayer Advocate Annual Report to Congress, IR-2013-3 (1/9/13).

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other *Principles of Good Tax Policy*³ as explained in a report we recently updated and issued.⁴ Our tax system must be administrable, support economic growth, have minimal compliance costs, and allow taxpayers to understand their tax obligations.

We believe these features are achievable if the following twelve principles of good tax policy are considered in the design of the system:

- Equity and Fairness
- Convenience of Payment
- Information Security
- Neutrality
- Transparency and Visibility
- Accountability to Taxpayers
- Certainty
- Effective Tax Administration
- Simplicity
- Economic Growth and Efficiency
- Minimum Tax Gap
- Appropriate Government Revenues

Our profession has long-advocated for a transparent tax system. For example, we urge Congress to use a consistent definition of taxable income without the use of phase-outs. Provisions, such as phase-out rules, that limit or eliminate the use of certain deductions and exclusions for those taxpayers in higher tax brackets, perpetuate the flaws of the current system, leading to nontransparent tax results and increased complexity. These rules also create marginal rates in excess of the statutory tax rate. In addition, multiple tax regimes, such as the alternative minimum tax (AMT), which applies in addition to the regular income tax makes it almost impossible for taxpayers, including small business owners, to easily know their effective and marginal tax rates. Multiple tax regimes also makes it difficult for owners to develop effective businesses plans. We urge Congress to use tax reform as an opportunity to remove phase-outs and multiple tax regimes, and develop the best definition of taxable income or adjusted gross income by creating simple, transparent, tax rules applied consistently across all rate brackets, eliminating additional complex and hidden taxes.

We also urge you to make tax provisions permanent. For all businesses, and small businesses in particular, uncertainty in the Internal Revenue Code (IRC or "Tax Code") creates unnecessary confusion and anxiety. Complexity can also result in taxpayers not taking full advantage of provisions intended to help them, resulting in higher taxes and greater compliance costs. While our Tax Code has always had a tendency to change, in recent years the rate of change has accelerated. Statutory changes result in new regulations, revenue procedures, notices and new or modified tax forms which take time and resources to understand and address. America's entrepreneurs need a Tax Code that is simple, transparent, and certain.

³ AICPA concept statement, "[Tax Policy Concept Statement 1, Guiding Principles for Good Tax Policy: A Framework for Evaluating Tax Proposals](#)," dated January 2017.

⁴ For an explanation of why and how the AICPA Principles of Good Tax Policy were updated, see "[Tax Principles for the Digital Age](#)," May 1, 2017.

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AICPA PROPOSALS

In the interest of good tax policy and effective tax administration for small businesses, we appreciate the opportunity to address the following issues:

1. Tax Rates for Pass-through Entities
2. Distinguishing Compensation Income
3. Cash Method of Accounting
4. Limitation on Interest Expense Deduction
5. Definition of "Compensation"
6. Net Operating Losses
7. Increase of Startup Expenditures
8. Alternative Minimum Tax Repeal
9. Mobile Workforce
10. Retirement Plans
11. Civil Tax Penalties
12. Tax Administration
13. IRS Deadline Related to Disasters
14. Other Small Business Tax Issues

1. Tax Rates for Pass-through Entities

As Congress moves forward with tax reform, it is important to recognize that a rate reduction for only C corporations is inappropriate. The vast majority of businesses are structured as pass-through entities (such as, partnerships, S corporations, or limited liability companies).⁵ In 2014, there were almost 25 million individual tax returns that included a non-farm sole proprietorship.⁶

Congress should continue to encourage, or more accurately – not discourage, the formation of sole proprietorships and pass-through entities because these business structures provide the flexibility and control desired by many new business owners as opposed to corporations which are subject to more formalities. Entrepreneurs generally do not want to create entities that require extra legal obligations (such as holding annual meetings of a board of directors). They prefer business structures that are simple and provide legal and tax advantages, such as the flow-through of early stage losses. As a business grows, however, it may need to change its structure to raise additional equity funding (such as, having employees become shareholders).

If Congress decides to lower income tax rates for C corporations⁷ (which are generally larger businesses), all business entity types including small businesses should also receive a rate reduction. Tax reform should not disadvantage sole proprietorships and pass-through entities

⁵ See Census Bureau, County Business Patterns; Census Bureau, Nonemployer Statistics.

⁶ IRS, Sole Proprietorship Returns, Tax Year 2014.

⁷ House Republican's Tax Reform Task Force, "A Better Way: Our Vision for a Confident America," June 24, 2016.

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at the expense of furthering larger C corporations, or require businesses to engage in complex entity changes to obtain favored tax status.

2. Distinguishing Compensation Income

We recognize that providing a reduced rate for active business income of sole proprietorships and pass-through entities will place additional pressure on the distinction between the profits of the business and the compensation of owner-operators. We recommend determining compensation income by using traditional definitions of "reasonable compensation" supplemented, if necessary, by additional guidance from the Secretary of the Treasury. Changes to existing payroll tax rules, such as a requirement for partnerships and proprietorships to charge reasonable compensation for owners' services and to withhold and pay the related income and other taxes, will also facilitate compliance for small businesses.

We encourage Congress to consider the existing judicial guidance on reasonable compensation that reflects the type of business (for example, labor versus capital intensive), the time spent by owners in operating the business, owner expertise and experience, and the existence of income-generating assets in the business (such as other employees and owners, capital and intangibles).

We acknowledge that reasonable compensation has been the subject of controversy and litigation (hence, the numerous court decisions helping to define it). Therefore, the IRS should take additional steps to improve compliance and administration in this area. For example, the creation of a new tax form (or preferably, modification of an existing form, such as Form 1125-E, *Compensation of Officers*) or a worksheet maintained with the taxpayer's tax records, would allow businesses to indicate the factors considered in determining compensation in a reasonable and consistent manner. These potential factors include:

- a. Approximate average hours per week worked by all owners;
- b. Approximate average hours worked per week by non-owner employees;
- c. The owner's years of experience;
- d. Guidance used to help determine reasonable compensation for the geographic area and years of experience (such as, wage data guides provided by the U.S. Bureau of Labor Statistics); and
- e. Book value and estimated fair market value of assets that generate income for the business.

Changes are also necessary for existing payroll tax rules to require partnerships and proprietorships to charge reasonable compensation for owners' services and to withhold and pay the related income and other taxes. These types of changes to existing payroll tax rules will facilitate small business compliance. The partners and proprietors are not treated as "employees," but rather owners subject to withholding – a new category of taxpayer – similar to a partner with a guaranteed payment for services. Similar rules requiring reasonable compensation currently exist in connection with S corporations and such owners are

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considered employees of the S corporation. The broader inclusion of partners and proprietors in more well defined compensation rules, should facilitate and enhance the development of appropriate regulations and enforcement in this area.

The AICPA believes there are advantages of this reasonable compensation approach for owners of all business types. These advantages include:

- a. Fairness that respects the differences among business types and owner participation levels;
- b. A reduced reliance by both taxpayers and the IRS on quarterly estimated tax payments for timely matching of the earning process and tax collection;
- c. Diminished reliance on the self-employment tax system (since businesses would include payroll taxes withheld from owners and paid for owners along with their employees); and
- d. Simplification from uniformity of collection of employment tax from business entities, and an ability to rely on a deep foundation of case law (in the S corporation and personal service corporation areas) to provide regulatory and judicial guidance.

In former Ways & Means Committee Chairman Dave Camp's 2014 discussion draft,⁸ a proposal was included to treat 70% of pass-through income of an owner-employee as employment income. While this proposal presents a simple method of determining the compensation component, it would result in an inaccurate and inequitable result in many situations. **If Congress moves forward with a 70/30 rule, or other percentage split, we recommend making the proposal a safe harbor option.** For example, the proposal must make clear that the existence and the amount of the safe harbor is not a maximum amount permitted but that the reasonable compensation standard utilized for corporations will remain available to sole proprietorships and pass-through entities. These rules will provide a uniform treatment among closely-held business entity types. **Appropriate reporting requirements, when the safe harbor option is not used, would also address the enforcement challenges currently faced by the IRS. For example, the modification of Form 1125-E would fully disclose factors considered in determining compensation that the IRS currently struggles to track.**

3. Cash Method of Accounting

The AICPA supports the expansion of the number of taxpayers who may use the cash method of accounting. The cash method of accounting is simpler in application than the accrual method, has fewer compliance costs, and does not require taxpayers to pay tax before receiving the income. Therefore, entrepreneurs often choose this method for small businesses. We are concerned with, and oppose, any new limitations on the use of the cash method for service businesses, including those businesses whose income is taxed directly on their owners' individual returns, such as partnerships and S corporations. Requiring businesses to switch to

⁸ H.R. 1 (113rd Congress), The Tax Reform Act of 2014, Sec. 1502; also see Section-by-Section Summary, pages 32-33.

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the accrual method upon reaching a gross receipts threshold unnecessarily creates a barrier to growth.⁹

The AICPA believes that limiting the use of the cash method of accounting for service businesses would:

- a. Discourage natural small business growth;
- b. Impose an undue financial burden on their individual owners;
- c. Increase the likelihood of borrowing;
- d. Impose complexities and increase their compliance burden; and
- e. Treat similarly situated taxpayers differently (because income is taxed directly on their owners' individual returns).

The AICPA believes that Congress should not further restrict the use of the long-standing cash method of accounting for the millions of U.S. businesses (e.g., sole proprietors, personal service corporations, and pass-through entities) currently utilizing this method. We believe that forcing more businesses to use the accrual method of accounting for tax purposes increases their administrative burden, discourages business growth in the U.S. economy, and unnecessarily imposes financial hardship on cash-strapped businesses.

4. Limitation on Interest Expense Deduction

Another important issue for small businesses is the ability to deduct their interest expense. New business owners incur interest on small business loans to fund operations prior to revenue generation, working capital needs, equipment acquisition and expansion, and even to build credit for larger future loans. These businesses rely on financing to survive. Equity financing for many start-up businesses is simply not available. A limitation in the deduction for interest expense (such as to the extent of interest income) would effectively eliminate the benefit of a valid business expense for many small businesses, as well as many professional service firms. If a limit on the interest expense deduction is paired with a proposal to allow for an immediate write-off of acquired depreciable property, it is important to recognize that this combination adversely affects service providers and small businesses while offering larger manufacturers, retailers, and other asset-intensive businesses a greater tax benefit.

Currently, small businesses can expense up to \$510,000 of acquisitions per year under section 179 and deduct all associated interest expense. One tax reform proposal¹⁰ under consideration would eliminate the benefit of interest expense while allowing immediate expensing of the full cost of new equipment in the first year. However, since small businesses do not usually purchase large amounts of new assets, this proposal would generally not provide any new benefit for smaller businesses (relative to what is currently available via the section 179

⁹ A required switch to the accrual method affects many small businesses in certain industries including accounting firms, law firms, medical and dental offices, engineering firms, and farming and ranching businesses.

¹⁰ House Republican's Tax Reform Task Force, "[A Better Way: Our Vision for a Confident America](#)," June 24, 2016.

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expensing rule). Instead, it only takes away an important deduction for many small businesses who are forced to rely on debt financing to cover their operating and expansion costs.

5. Definition of "Compensation"

Tax reform discussions have recently considered whether the tax system should use the same definition for taxable compensation of employees as it does for the compensation that employers may deduct. In other words, should businesses lose some of their current payroll-type deductions if employees are not required to report those same compensation amounts as income?

We are concerned, particularly from a small business perspective, about any decrease of an employer's ability to deduct compensation paid to employees, whether in the form of wages or fringe benefits (health and life insurance, disability benefits, deferred compensation, etc.). We are similarly concerned about expansion of the definition of taxable income for the employees, or removal of the exclusion for fringe benefits. Such changes in the Tax Code would substantially impact the small and labor-intensive businesses' ability to build and retain a competitive workforce.

6. Net Operating Losses

Congress should also provide tax relief to small businesses in the calculation of benefits related to net operating losses (NOLs). An NOL is generally the amount by which a taxpayer's business deductions exceed its gross income. Corporations currently operating at a loss can benefit from carrying these NOLs back or forward to offset taxable income. According to the current rules, these losses are not deducted in the year generated, but carried back two years and carried forward 20 years to offset taxable income in such years.

One of the purposes of the NOL carryback and carryover rules is to allow a taxpayer to better reflect its economic position over a longer period of time than generally is allowed under the restraint of the annual reporting period. Since 1987, our experience with the 90% AMT limitation on the use of NOLs shows that this limitation often imposes a tax on corporations, especially small businesses in their early growth years, when such businesses are still struggling economically. Therefore, a proposal¹¹ for a 90% limitation on NOLs imposes an artificial restriction on a company's use of business losses and discriminates against companies with volatile income which could potentially pay more tax than companies with an equal amount of steady income over the same period.

For sole proprietors, the calculation of the NOL is overly complicated. Congress should simplify the calculation while retaining the carryback option for small businesses. Most startup businesses are formed as pass-through entities¹² and the initial startup losses incurred are "passed down" and reported on the owners' tax returns. Because individual taxpayers report

¹¹ *Id.*

¹² Center for American Progress, "[Ending the Pass-Through Tax Loophole for Big Business](#)," August 2016.

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both business and nonbusiness income and deductions on their returns, the required calculations to separate allowed business losses from disallowed personal activities is complex.¹³ Individual business owners would benefit from more specific guidance on NOL computations.

7. Increase of Startup Expenditures

In the interest of economic growth, we encourage Congress to consider increasing the expensing amount for startup expenditures. Section 195 allows immediate expensing of up to \$5,000 of startup expenditures in the tax year in which the active trade or business begins. This amount is reduced dollar for dollar once total startup expenditures exceed \$50,000, with the excess amortized ratably over 15 years. Thus, once startup expenditures exceed \$55,000, all of these expenditures are amortized over 15 years. The rationale for the \$5,000 expensing was to "help encourage the formation of new businesses that do not require significant startup or organizational costs."¹⁴ These dollar amounts, added in 2004, are not adjusted for inflation. Only for tax years beginning in 2010, the \$5,000 was increased to \$10,000 and the \$50,000 phase-out level was increased to \$60,000. This change was described as "promoting entrepreneurship."¹⁵

The AICPA recommends increasing the \$5,000 and \$50,000 amounts of section 195 and adjusting them annually for inflation. These changes will further simplify tax compliance for small businesses by reducing (or eliminating) the number of such businesses that must track and report amortization of startup expenses over a 15-year period. In addition, as was suggested for the 2004 and 2010 legislative changes, the larger dollar amounts will better encourage entrepreneurship. Higher dollar amounts also reflect the costs for legal, accounting, investigatory, and travel that are frequently incurred when starting a new business. Also, in light of the increased, inflation-adjusted dollar amounts under section 179¹⁶ to help small businesses, it is appropriate to similarly increase the section 195 dollar amounts and adjust them annually for inflation.

8. Alternative Minimum Tax Repeal

Congress should repeal AMT for both individuals and corporations. The current system's requirement for taxpayers to compute their income for purposes of both the regular income tax and the AMT is a significant area of complexity of the Tax Code requiring extra calculations and recordkeeping. AMT also violates the transparency principle in masking what a taxpayer is allowed to deduct or exclude, as well as the taxpayer's marginal tax rate. Owners of small

¹³ IRS Publication 536.

¹⁴ P.L. 108-357 (10/22/04), American Jobs Creation Act, Sec. 902; Joint Committee on Taxation, General Explanation of Tax Legislation Enacted In the 108th Congress, JCS-5-05, May 31, 2005, p. 504.

¹⁵ The one year change to the \$195 dollar amounts was made by P.L. 111-240 (9/27/10), the Small Business Jobs Act of 2010, Sec. 2031(a); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress, JCS-2-11, March 2011, p. 474.

¹⁶ P.L. 114-113 (12/18/15), Sec. 124(a).

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businesses, including those businesses operating through pass-through entities and certain C corporations, are increasingly at risk of being subject to AMT.

The AMT was created to ensure that all taxpayers pay a minimum amount of tax on their economic income. However, small businesses suffer a heavy burden because they often do not know whether they are affected until they file their taxes. They must constantly maintain a reserve for possible AMT, which takes away from resources they could allocate to business needs such as hiring, expanding, and giving raises to workers.

The AMT is a separate and distinct tax regime from the "regular" income tax. IRC sections 56 and 57 create AMT adjustments and preferences that require taxpayers to make a second, separate computation of their income, expenses, allowable deductions, and credits under the AMT system. This separate calculation is required for all components of income including business income for sole proprietors, partners in partnerships and shareholders in S corporations. Small businesses must maintain annual supplementary schedules used to compute these necessary adjustments and preferences for many years to calculate the treatment of future AMT items and, occasionally, receive a credit for them in future years. Calculations governing AMT credit carryovers are complex and contain traps for unwary taxpayers.

Sole proprietors who are also owners in pass-through entities must combine the AMT information from all their activities in order to calculate AMT. The computations are extremely difficult for business taxpayers preparing their own returns and the complexity also affects the IRS's ability to meaningfully track compliance.

9. Mobile Workforce

The AICPA supports the Mobile Workforce State Income Tax Simplification Act of 2017, S. 540, which provides a uniform national standard for non-resident state income tax withholding and a *de minimis* exemption from the multi-state assessment of state non-resident income tax.¹⁷

The current situation of having to withhold and file many state nonresident tax returns for just a few days of work in various states is too complicated for both small businesses and their employees. Businesses, including small businesses and family businesses that operate interstate, are subject to a multitude of burdensome, unnecessary and often bewildering non-resident state income tax withholding rules. These businesses struggle to understand and keep up with the variations from state to state. The issue of employer tracking and complying with all the different state and local tax laws is quite complicated, consumes a lot of time and is costly.

¹⁷ For additional details, see AICPA written statement, "AICPA Statement for the Record of the April 13, 2016 Hearing on "Keep it Simple: Small Business Tax Simplification and Reform, Main Street Speaks," dated April 7, 2016.

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S. 540 would provide long-overdue relief from the current web of inconsistent state income tax and withholding rules on nonresident employees. Therefore, we urge Congress to pass S. 540 that provides national uniform rules and a reasonable 30 day *de minimis* threshold before income tax withholding is required.

10. Retirement Plans

Small businesses are especially burdened by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. Currently, there are four employee contributory deferral plans: 401(k), 403(b), 457(b), and SIMPLE plans. Having four variations of the same plan type causes confusion for many plan participants and small businesses. Congress should eliminate the unnecessary complexity by reducing the number of choices for the same type of plan while keeping the desired goal intact: affording employers the opportunity to offer a contributory deferral plan to their employees and allowing those employees to use a uniform plan to save for retirement.

Startup business owners are inundated with a myriad of new business decisions and concerns. These individuals may have expertise in their business product or service, but rarely are they experts in areas such as retirement plan rules and regulations. We encourage Congress to consider creating a uniform employee contributory deferral plan to ease this burden for small businesses.

11. Civil Tax Penalties

Congress should carefully draft penalty provisions and the Administration should fairly administer the penalties to ensure they deter bad conduct without deterring good conduct or punishing innocent small businesses owners (i.e., unintentional errors, such as those who committed the inappropriate act without intent to commit such act). Targeted, proportionate penalties that clearly articulate standards of behavior and are administered in an even-handed and reasonable manner encourage voluntary compliance with the tax laws. On the other hand, overbroad, vaguely-defined, and disproportionate penalties create an atmosphere of arbitrariness and unfairness that can discourage voluntary compliance.

The AICPA has concerns¹⁸ about the current state of civil tax penalties and offers the following suggestions for improvement:

a. Trend Toward Strict Liability

The IRS discretion to waive and abate penalties where the taxpayer demonstrates reasonable cause and good faith is needed most when the tax laws are complex and the potential sanction is harsh. Legislation should avoid mandating strict liability penalties. Over the past several decades, the number of increasingly severe civil tax penalties have grown, with the Tax Code currently containing eight strict liability

¹⁸ See AICPA whitepaper, "[AICPA Tax Penalties Legislative Proposals](#)," dated April 2013; and the "[AICPA Report on Civil Tax Penalties](#)," submitted April 2013.

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penalty provisions (for example, the accuracy penalty on non-disclosed reportable transactions).¹⁹

b. An Erosion of Basic Procedural Due Process

Taxpayers should know their rights to contest penalties and have a timely and meaningful opportunity to voice their feedback before assessment of the penalty. In general, this process would include the right to an independent review by the IRS Appeals office or the IRS's FastTrack appeals process, as well as access to the courts. Pre-assessment rights are particularly important where the underlying tax provision or penalty standards are complex, the amount of the penalty is high, or fact-specific defenses such as reasonable cause are available.

c. Repeal Technical Termination Rule

We recommend the repeal of section 708(b)(1)(B) regarding the technical termination of a partnership. A technical termination most often occurs when, during a 12-month period there is a sale or exchange of 50% or more of the total interest in partnership capital and profits. Because this 12-month time frame can span a year-end, the partnership may not realize that a 30% change (a minority interest) in one year followed by a 25% change in another year, but within 12 months of the first, has caused the partnership to terminate.

In practice, this earlier required filing of the old partnership's tax return often goes unnoticed because the business is unaware of the accelerated deadline due to of the equity transfer. Penalties are often assessed upon the business as a result of the missed deadline. This technical termination area is often misunderstood and misapplied. The acceleration of the filing of the tax return, to reset depreciation lives and to select new accounting methods, serves little purpose in terms of abuse prevention and serves more as a trap for the unwary.

d. Late Filing Penalties of Sections 6698 and 6699

Sections 6698 and 6699 impose a penalty of \$200 per owner related to late-filed partnership or S corporation returns. The penalty is imposed monthly not to exceed 12 months, unless it is shown that the late filing is due to reasonable cause.

The AICPA proposes that a partnership, comprised of 50 or fewer partners, each of whom are natural persons (who are not nonresident aliens), an estate of a deceased partner, a trust established under a will or a trust that becomes irrevocable when the grantor dies, and domestic C corporations, is considered to have met the reasonable cause test and is not subject to the penalty imposed by section 6698 or 6699 if:

¹⁹ Section 6662A, 6664(d).

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- The delinquency is not considered willful under section 7423;
- All partnership income, deductions and credits are allocated to each partner in accordance with such partner's capital and profits interest in the partnership, on a pro-rata basis; and
- Each partner fully reported its share of income, deductions and credits of the partnership on its timely filed federal income tax return.

e. Failure to Disclose Reportable Transactions

Taxpayers who fail to disclose a reportable transaction are subject to a penalty under section 6707A of the Tax Code. The section 6707A penalty applies even if there is no tax due with respect to the reportable transaction that has not been disclosed. There is no reasonable cause exception to this penalty.

Under section 6662A, taxpayers who have understatements attributable to certain reportable transactions are subject to a penalty of 20% (if the transaction was disclosed) and 30% (if the transaction was not disclosed). A more stringent reasonable cause exception for a penalty under section 6662A is provided in section 6664, but only where the transaction is adequately disclosed, there is substantial authority for the treatment, and the taxpayer had a reasonable belief that the treatment was more likely than not proper. In the case of a listed transaction, reasonable cause is not available, similar to the penalty under section 6707A.

For example, a company that engaged in a "listed" transaction which gave rise to a deduction of \$25,000 over the course of two years and inadvertently failed to report the transaction may be subject to a \$200,000 penalty per year, for a total penalty of \$400,000. The penalty can apply even if the deduction is allowable.

We propose an amendment of section 6707A to allow an exception to the penalty if there was reasonable cause for the failure and the taxpayer acted in good faith for all types of reportable transactions, and to allow for judicial review in cases where reasonable cause was denied. Moreover, we propose an amendment of section 6664 to provide a general reasonable cause exception for all types of reportable transactions, irrespective of whether the transaction was adequately disclosed or the level of assurance.

f. 9100 Relief

Section 9100 relief, which is currently available with regard to some elections, is extremely valuable for taxpayers who inadvertently miss the opportunity to make certain tax elections. Congress should make section 9100 relief available for all tax elections, whether prescribed by regulation or statute. The AICPA has compiled a list²⁰ of elections (not all-inclusive) for which section 9100 relief currently is not granted by

²⁰ AICPA comment letter, "[Tax Reform Administrative Relief for Various Statutory Elections](#)," dated January 23, 2015.

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the IRS as the deadline for claiming such elections is set by statute. Examples of these provisions include section 174(b)(2), the election to amortize certain research and experimental expenditures, and section 280C(c), the election to claim a reduced credit for research activities.

g. Form 5471 Penalty Relief

On January 1, 2009, the IRS began imposing an automatic penalty of \$10,000 for each Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, filed with a delinquent Form 1120, *U.S. Corporation Income Tax Return*, series return. When imposing the penalty on corporations in particular, the IRS does not distinguish between: a) large public multinational companies, b) small companies, and c) companies that may only have insignificant overseas operations, or loss companies. This one-size-fits-all approach inadvertently places undue hardship on smaller corporations that do not have the same financial resources as larger corporations. The AICPA has submitted recommendations²¹ regarding the IRS administration of the penalty provision applicable to Form 5471. Our recommendations focus on the need for relief from automatic penalties assessed upon the late filing of Form 5471 in order to promote the fair and efficient administration of the international penalty provisions of the Tax Code.

12. Tax Administration

As we approach the 20th anniversary of the Report of the National Commission on Restructuring the IRS ("Restructuring Commission"), we recommend that any effort to modernize the IRS and its technology infrastructure should build on the foundation established by the Restructuring Commission. The current degradation of the IRS taxpayer services is unacceptable. The percentage of calls from taxpayers the IRS answered between 2004 and 2016 has dropped from 87% to 53%, however, the need for taxpayer assistance increased (the number of calls the IRS received increased from 71 million to 104 million).²²

As tax professionals, we represent one of the IRS's most significant stakeholder groups.²³ As such, we are both poised and committed to being part of the solution for improving IRS taxpayer services. We recently submitted a letter²⁴ to House Ways and Means Committee and Senate Finance Committee members in collaboration with other professional organizations. Our recommendations include modernizing IRS business practices and technology, re-establishing the annual joint hearing review, and enabling the IRS to utilize the full range of available authorities to hire and compensate qualified and experienced professionals from the

²¹ AICPA comment letter to the IRS, "Recommendations – Automatic Penalties Assessments Policy with the Late Filing of Form 5471," dated March 26, 2013.

²² National Taxpayer Advocate, *Annual Report to Congress 2016, Executive Summary: Preface, Special Focus and Highlights*, 2016, page 16.

²³ 60% of all e-filed returns in 2016 were prepared by a tax professional, according to the Filing Season Statistic for Week Ending Dec. 2, 2016.

²⁴ AICPA comment letter, "Ensuring a Modern-Functioning IRS for the 21st Century," dated April 3, 2017.

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private sector to meet its mission. The legislative and executive branches should work together to determine the appropriate level of service and compliance they want the IRS accountable for and then dedicate appropriate resources for the Service to meet those goals.

Additionally, we recommend the IRS create a new dedicated practitioner services unit to rationalize, enhance, and centrally manage the many current, disparate practitioner-impacting programs, processes, and tools. Enhancing the relationship between the IRS and practitioners would benefit both the IRS and the millions of taxpayers, including small businesses, served by the practitioner community. As part of this new unit, the IRS should provide practitioners with an online tax professional account with access to all of their clients' information. The IRS should offer robust practitioner priority hotlines with higher-skilled employees that have the experience and training to address complex issues. Furthermore, the IRS should assign customer service representatives (a single point of contact) to geographic areas in order to address challenging issues that practitioners could not resolve through a priority hotline.

13. IRS Deadlines Related to Disasters

Similar to IRS's authority to postpone certain deadlines in the event of a presidentially-declared disaster, Congress should extend that limited authority to state-declared disasters and states of emergency. Currently, the IRS's authority to grant deadline extensions, outlined in section 7508A, is limited to taxpayers affected by federal-declared disasters. State governors will issue official disaster declarations promptly but often, presidential disaster declarations in those same regions are not declared for days, or sometimes weeks after the state declaration. This process delays the IRS's ability to provide federal tax relief to impacted businesses and disaster victims. Taxpayers have the ability to request waivers of penalties on a case-by-case basis; however, this process causes the taxpayer, tax preparer, and the IRS to expend valuable time, effort, and resources which are already in shortage during times of a disaster. Granting the IRS specific authority to quickly postpone certain deadlines in response to state-declared disasters allows the IRS to offer victims the certainty they need as soon as possible.

This past year, multiple states along Southeastern U.S. were affected by Hurricane Matthew, including Florida, Georgia, North and South Carolina, and Virginia. From October 6 through 10, Matthew traveled north along the southeast coast. A federal state of emergency was declared for Florida on October 6 and later extended to include Georgia and South Carolina. Tax preparers and taxpayers living in the affected regions not only lost access to power and the internet, but lost tax documents and financial information due to flooding and destruction of both their homes and businesses. On October 13, 2016, the IRS issued IR-2016-132 offering federal tax relief to regions of North Carolina. The relief arrived two days before the major October 15 extended tax filing deadline – which caused tax practitioners unnecessary stress and burden for the days leading up to the issuance of the relief. Three days *after* the extended filing deadline, on October 18, the IRS issued relief for Florida and Georgia – which was, unfortunately, too late to make a substantial difference.

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More recently, on March 13, 2017, Winter Storm Stella hit the Northeast and Mid-Atlantic U.S. covering many states in multiple feet of snow two days before the March 15 business return due date. Before 2:00 pm (ET) on the first day of the storm, governors in New York and other states began issuing emergency declarations while the AICPA and state CPA societies along the northeast received calls from members needing federal filing relief from the IRS. Two days later, at approximately 4:30 pm (ET) on the March 15 filing due date, the IRS finally issued [IR-2017-61](#) offering business taxpayers affected by Winter Storm Stella additional time to file. Receiving federal extensions are helpful, but the sooner the IRS can grant this relief, the greater the beneficial impact on victims.

The AICPA has long supported a set of permanent disaster relief tax provisions²⁵ and we acknowledge both Congress's and the IRS's willingness to help disaster victims. To provide more timely assistance, however, we recommend that Congress allow the IRS to postpone certain deadlines in response to state-declared disasters or state of emergencies.

14. Other Small Business Tax Compliance Issues

There are several other small business tax compliance burden proposals that we support, including:

a. Listed Property

We suggest removing "computer or peripheral equipment" from the definition of "listed property" in order to simplify and modernize the traditional tax treatment of computers and laptops.²⁶ Classifying computers and similar property as "listed property" under section 280F is clearly outdated in a business environment where employees are increasingly expected to work outside of traditional business hours. Various forms of technology, including laptops, tablets and cell phones, are all converging to serve similar purposes. The costs for the internet and service plans are now frequently sold in "bundles" and shared between multiple devices and it has become arguably impossible to segregate the cost of service between a cell phone, tablet, and laptop. The AICPA believes legislative change to update the treatment of mobile devices is the best simplification, similar to section 2043 of the Small Business Jobs Act of 2010, where cell phones were removed from the definition of listed property for taxable years beginning after December 31, 2009.

b. Executive Compensation

The AICPA supports that section 409A requirements should apply only to public companies.²⁷ Section 409A, which applies to compensation earned in one year but paid in a future year, was enacted to protect shareholders and other taxpayers from

²⁵ AICPA comment letter, "[Request for Permanent Tax Provisions Related to Disaster Relief](#)," dated November 22, 2013.

²⁶ AICPA [written statement](#), "Targeted Tax Reform: Solutions to Relieve the Tax Compliance Burden(s) for America's Small Businesses," dated July 22, 2015.

²⁷ *Id.*

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executives guarding their own financial interests without concern for the financial interests of the organization, its shareholders or other creditors.

The rules apply to a broad array of compensation arrangements, including many business arrangements that are not thought of as deferred compensation. Nonpublic companies often want arrangements with employees to allow for sharing equity or providing capital accumulation for long-term employees, and constraining the nonpublic business owner by rules designed to protect absentee shareholders should not occur.

Many nonpublic entities have noncompliant plans that are not correctable under the existing administrative correction programs. The cost of a noncompliant 409A plan is excessive given the unintended violations. In addition to accrual base income recognition, the additional 20% tax applies to the recipient, often a person unknowingly affected by the violations. Requiring private companies to pay for the specialized tax guidance needed to ensure that a compensatory arrangement is 409A compliant should not occur. The cost of imposing 409A requirements on nonpublic companies is far in excess of any benefit derived.

c. Elimination of Top-Heavy Rules (for Retirement Plans)

Small businesses are especially burdened by the overwhelming number of rules inherent in adopting and operating a qualified retirement plan. Therefore, we support repealing the sole remaining top-heavy rule, which limits the adoption of 401(k) and other qualified retirement plans by small employers and requires a minimum contribution or benefit.²⁸ The determination of top-heavy status is difficult and the required 3% minimum contribution is often made for safe harbor 401(k) plans. Without the top-heavy rules, more small businesses would adopt plans to benefit their employees.

d. Provide Full Deductibility of Health Insurance

We recommend allowing full deductibility of health insurance costs in calculating the self-employment tax for self-employed individuals.²⁹ This suggestion would provide that deductions allowed in determining income subject to Survivors, and Disability Insurance (OASDI) and health insurance (HI) taxes remain consistent amongst taxpayers regardless of whether they are employees or self-employed individuals. Currently, employees receive this deduction for their health insurance costs while self-employed individuals are not allowed a deduction in determining their net income subject to these taxes. The calculation of income subject to a particular tax should remain consistent amongst all taxpayers.

²⁸ Since top-heavy rules were enacted in 1982, there have been a number of statutory changes which have significantly decreased their effectiveness. For additional details see AICPA comment letter, "[AICPA Suggestions to Tax Reform Working Group on Savings and Investments](#)," dated March 6, 2015.

²⁹ For additional details, see "[2017 AICPA Compendium of Tax Legislative Proposals – Simplification and Technical Proposals](#)", December 14, 2016.

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e. Increase the Passive Income Percentage to 60% and Eliminate the Three Year Termination for S Corporations

The AICPA recommends increasing the threshold of an S corporation's income that is considered passive without incurring an entity-level tax to 60% (from 25%).³⁰ Additionally we recommend eliminating the current rule that terminates an S corporation's pass-through status if the S corporation has excess passive income for three consecutive years.

Currently, if an S corporation has excess passive income for three consecutive years, even though incurring a corporate-level tax is a possibility due to the taxable income limitation, the S election is subject to termination, creating uncertainty in S corporation operations. Under current law, if the S corporation unknowingly has \$1.00 of accumulated earnings and profits, the S election is terminated if the S corporation has excess passive investment income for three consecutive years. The IRS routinely grants waivers of the involuntary termination under section 1362(d)(3). S corporations without C corporation earnings and profits may receive an unlimited amount of passive investment income and are not subject to the S election termination.

f. Guidance Needed on Emerging Issues

Online crowdfunding and the sharing economy are quickly expanding mediums through which individuals obtain funds, seek new sources of income, and start and grow businesses. Individuals may understand the steps through which they can use these new crowdfunding and sharing economy opportunities to their advantage. However, many tax preparers and their clients do not have the guidance necessary to accurately comply with the complex, out-of-date, or incomplete tax rules in these emerging areas.

Lawmakers and tax administrators must regularly review existing laws, against new changes in the ways of living and doing business, to determine whether tax rules and administration procedures need modification and modernization. We urge Congress and the IRS to develop simplified tax rules and related guidance in the emerging sharing economy and crowdfunding areas.³¹ Some of the areas in need of modernization include information reporting (such as to avoid reporting excluded income, such as a gift, as income), simplicity in reporting and tracking rental losses from year to year, and simplified approaches for recordkeeping for small businesses. Offering clarity on these issues will allow taxpayers to follow a fair and transparent set of guidelines while the IRS benefits from a more efficient voluntary tax system. In addition, it is not recommended to bypass these evolving opportunities of connecting businesses and customers, and generating funds for equity and sales, due to entrepreneurs concerned about uncertain tax effects.

³⁰ *Id.*

³¹ AICPA [written statement](#), "The 2017 Filing Season: IRS Operations and the Taxpayer Experience," dated April 6, 2017.

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CONCLUDING REMARKS

Tax compliance requirements have become an everyday burden for small businesses. The current complexity and uncertainty of the Tax Code forces small businesses to utilize critical resources and can hinder their ability to grow and create jobs. As Congress tackles the complex issues inherent in drafting tax legislation, we encourage you to consider tax reform that will provide simplicity, certainty and clarity for small business owners.

The AICPA has consistently supported tax reform simplification efforts because we are convinced such actions will significantly reduce small businesses' compliance costs and fuel economic growth. The AICPA appreciates the opportunity to testify and we look forward to working with the Committee as you continue to address the needs of small businesses and their owners.

Chairman RISCH. Thank you very much. Mr. Reardon.

**TESTIMONY OF BRIAN REARDON, PRESIDENT, S
CORPORATION ASSOCIATION**

Mr. REARDON. Thank you, Chairman, Ranking Member Shaheen. I appreciate the opportunity to testify here today.

I have managed the S Corp Association for the past 12 years, and during that time we have developed a number of research pieces, a number of themes to help education policymakers on the importance of the pass-through community and on the priorities of the pass-through community and tax reform, and I would like to hit a couple of those themes here today.

The first theme is that small business is really big. The pass-through sector—that is S corporations, partnerships, LLCs, and sole proprietorships—they employ more people, they employ the majority of private-sector workers in the country, and they earn the majority of business income in the country. In fact, 57 percent of private-sector workers get up every day and they go to work at a pass-through business. In some states, some of the states that you guys actually represent, they employ nearly 7 out of 10 workers.

So if tax reform is going to be successful at returning jobs and money to the United States, it needs to include pass-through businesses at the beginning of the conversation, and not just as an afterthought.

Second, the business tax base is getting bigger. We hear a lot about erosion of the corporate tax base, and the implication is that this is a bad thing. But the reality is that since 1986, the business tax base, the corporate sector and the pass-through sector, is bigger today than it was back in 1986, and growth is completely due to the growth of the pass-through sector, and that growth is a good thing. It is something to be celebrated. It is not something to be worried about.

The reason that it is something to be celebrated is point three, which is moving business activity away from the harmful double corporate tax and towards pass-through treatment is good for the economy. We hired Ernst & Young back in 2011 to give us a sense of both the economic footprint of the pass-through community but also the economic contribution, and what they found is that there are more jobs and more investment in the economy with the current system, with pass-throughs being a robust part of the economy, than if all businesses were structured as C corporations.

The fourth point is that pass-throughs pay their fair share. They may not pay the corporate tax but they do pay taxes, they do pay it when it is earned, and they pay a lot of taxes. We hired a firm back in 2013 to measure the effect of tax rates of all businesses by structure, so S corp, partnerships, C corp, et cetera. What they found is that S corps pay the highest effective tax rate, 32 percent. Large S corps, those with more than \$10 million in income, pay over 35 percent effective tax rate. That is no margin rate. That is the effective. That is how much they actually pay. That compares to 29 percent for partnerships, 15 for sole proprietorships, and 27 percent for C corps. The bottom line is the pass-through community is paying its fair share in taxes.

And then, finally, the last statement is that taxes on those pass-through businesses just went up, starting in 2013. One of the reasons that the effective rate for S corporations and partnerships is so high is that they pay higher rates. As a result of the fiscal cliff and the Affordable Care Act taxes, the top rates on pass-through businesses increased from 35 percent in 2012, to 44 percent in 2013. When you combine those taxes with State and local taxes, some pass-through businesses face marginal rates of over 50 percent, and in the back of my written testimony we have a chart showing the marginal rates for each state when you add in the local and State taxes.

With those facts in mind, the Main Street business communities coalesced around the following three principles for tax reform. First, it needs to be comprehensive. That is, individual, pass-through, and corporate. Second, it needs to lower rates for pass-through and C corps alike, to try to restore the rate parity that we had from 2003 to 2012. And then, finally, it should seek to reduce or eliminate the double tax on C corporations. Last year, 120 trade associations signed on to those three pass-through principles. It includes the Farm Bureau, NFIB, the restaurant associations, most of the major national groups.

The good news is that most of the plans that are under consideration right now embrace those principles. They are comprehensive, they all seek to restore rate parity, and they all seek to reduce the double tax on C corporations.

They also include a number of provisions that are important to Main Street businesses that Annette mentioned. One is repeal of the estate tax, the second is repeal of the AMT, the third is repeal of the ACA surtax, and the final one is to increase small business expensing beyond its current limits. When you couple those provisions with rate reduction, these provisions would sharply reduce the effective tax rates paid by pass-through businesses while dramatically simplifying the tax code.

So that is it. Those are the priorities for the pass-through community. I really appreciate the opportunity to testify here today and I am happy to take any questions.

[The prepared statement of Mr. Reardon follows:]



Testimony before the Senate Committee on Small Business
"Tax Reform: Removing Barriers to Small Business Growth"

Brian Reardon -- President, S Corporation Association
June 14, 2017

Congress created S corporations over fifty years ago explicitly to encourage private enterprise -- and it worked. Today there are 4.7 million S corporations.¹ They are in every community and they are engaged in every type of industry. Their emergence has made the US economy larger and more flexible, resulting in more employment, more investment, and a stronger safety-net against economic downturns like the recent financial crisis.

Despite this success, the debate over reforming business taxation has focused primarily on C corporations and their challenges. US-based C corporations pay some of the highest tax rates in the world, and they are hamstrung by an outdated worldwide system that chases their income wherever it is earned. As a result, the tax code encourages our public companies to shift jobs, investment, and even their headquarters overseas. To address this, Congress needs to enact reforms that fix the tax code for C corporations.

But pass through businesses, including S corporations, face the same challenges as C corporations. The C corporation tax rate may be among the highest in the world, but the tax rate paid by S corporations is even higher. Moreover, pass through businesses have a bigger economic footprint than C corporations -- they employ more people and they contribute more to national income. So any reform needs to be permanent, comprehensive, and treat pass through businesses as equal partners.

This is an argument we have been making for several years, and during that time we have developed a number of themes that help explain both the importance of the pass through community to investment and jobs here in the United States, and the reasons why Congress should enact permanent, comprehensive tax reform that reduces tax rates for pass through businesses and C corporations alike.

1. Start with S Corporations

The S corporation structure is the correct way to tax business income. If Congress were starting from scratch, it would begin with the S corporation as the base model. There are three key reasons why this is the case.

¹ IRS SOI



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- First, S Corporation income is taxed just once, which is the correct way to tax business income. Multiple layers of taxation raise effective tax rates and they distort business behavior. There is a reason why only a small minority of C corporations pay dividends – they are adjusting their behavior to avoid that second layer of tax. Business income should be taxed once at a reasonable rate and then that's it.
- Second, S corporation income is taxed when it is earned and it is taxed regardless of whether the income is “distributed” to shareholders. There is no election or deferral in paying tax on S corporation income.
- Finally, S corporation income is taxed at progressive rates tied to a shareholder's income. Wealthy S corporation shareholders pay high marginal rates while lower income shareholders pay lower rates. This contrasts with the C corporation model where, with few exceptions, most C corporation shareholders pay the same marginal tax, regardless of their income.

Congress should keep these advantages in mind as it tackles tax reform. Tax reform should move the tax code towards the pass through model, not away from it.

2. The Business Tax Base is Growing, Not Shrinking

We often hear observation that the corporate tax base has shrunk since 1986, usually as a prelude to calling for expanding the reach of the corporate tax. The reality, however, is that the overall business tax base is growing, not shrinking. Businesses play a bigger role in the American economy today than they did prior to 1986, entirely due to the contributions of pass through businesses, including S corporations.

Prior to 1986, traditional C corporation income made up approximately 8 percent of GDP while pass through income, including S corporations, made up just one percent, for a total of 9 percent. Today, C corporations contribute 5 percent of GDP while pass through businesses add 6 percentage points – a total of 11 percent of GDP.² That bigger share of the overall economy means more jobs and more investment.

So instead of decrying the “erosion” of the corporation tax base, the tax community should be celebrating the growth of the “business” tax base. It's a good news story.

3. The Business Community Has Voted for a Single Layer of Tax

This shift away from the traditional corporate form is reflective of a broader theme, where the business community is migrating away from the harmful double corporate tax. For example,

² http://taxfoundation.org/article/america-s-shrinking-corporate-sector?mc_cid=275125da58&mc_eid=8aee3da63d



the Tax Foundation found that in 2012 that pass through businesses earned nearly 60 percent of business income (single layer) while C corporations earned only 40 percent (double taxation).³ These income numbers suggest a majority of business income today is not subject to the double tax.

The shift to a single layer of tax is even more profound than those numbers suggest. The Tax Policy Center⁴ recently reported that only one-quarter of US corporate stock today is owned in taxable accounts, down from four-fifths back in 1965. The rest is held by qualified plans, endowments, charities, foreign accounts, etc. This suggests that about 90 percent of all business income (pass through income plus three-quarters of C corporation income) is subject to a single layer of tax.

Congress may be seeking ways to improve the tax code and reduce the double tax on corporate America, but the business community is already there. Proposals to integrate the corporate tax, as suggested by Chairman Hatch (R-UT) and the Bush Treasury Department, would help the tax code catch up to the reality of business taxation today.

4. Pass Through Business Employ Most Workers

While businesses organized as S corporations, partnerships and sole proprietorships are generally labeled “small,” their cumulative contribution to the economy is large, starting with employment.

The most recent numbers from the Tax Foundation found that 57 percent of private sector workers were employed at pass through businesses, with S corporations employing one in four⁵. According to the Tax Foundation:

- Pass Through Businesses – 73 million (57 percent)
- S corporations – 33 million
- Partnerships – 14 million
- Sole Proprietorships – 26 million
- C Corporations – 54 million (43 percent)

States with the highest levels of pass through employment include Montana, South Dakota, Idaho and Vermont. Only Hawaii has pass through employment levels below 50 percent. Large pass through businesses are also a significant source of employment, with more than 10 million people working at pass through businesses with more than 500 employees.

³ <https://taxfoundation.org/pass-through-businesses-data-and-policy/>

⁴ <http://www.taxpolicycenter.org/taxvox/only-about-one-quarter-corporate-stock-owned-taxable-shareholders>

⁵ <https://taxfoundation.org/pass-through-businesses-data-and-policy/>



5. Pass Through Businesses Pay Their Fair Share of Tax

A critique of S corporations is that they “avoid” the corporate tax, with the implication being that they either don’t pay taxes at all or pay insufficient levels of tax. This critique is simply untrue. S corporations pay taxes on their business income when it is earned, and often at higher rates than C corporations.

In 2013 we asked an econometric firm to measure⁶ the effective tax rates of businesses by type – C corporation, S corporation, partnership, and sole proprietorship. They found that S corporations, and particularly large S corporations, pay the highest effective federal tax rate:

- Sole Proprietorships: 15 percent
- C corporations: 27 percent
- Partnerships: 29 percent
- S corporations: 32 percent
- Large S corporations: 35 percent

For pass through businesses, these results show what you might expect. Sole proprietorships are generally informal smaller enterprises with lower effective tax rates while partnerships and S corporations tend to be larger and more formal, so they tend to have higher effective tax rates.

And while effective rates on C corporations have been studied extensively with varying results, the point here is that pass through businesses, and in particular S corporations, already pay their fair share and then some. Policymakers should keep this in mind as they seek to reform how businesses pay tax.

6. Pass Through Taxes Just Went Up

Finally, it is important to remind policymakers that, as a result of the resolution of the fiscal cliff and the implementation of a new Affordable Care Act tax, marginal tax rates on pass through businesses went up sharply beginning in 2013.

First, top marginal rates on pass through businesses rose from 35 to 39.6 percent. Second, the restoration of the Pease limitation on itemized deductions has the effect of increasing marginal rates by another 1.2 percent. And finally, the implementation of the new ACA Investment Surtax adds another 3.8 percent on S corporation shareholders who do not work at the business.

⁶ http://www.s-corp.org/wp-content/uploads/2013/08/Quantria_Study_ETR_8-6-13_Final_pm.pdf



The cumulative effect of these changes was to raise the top marginal rate on S corporation shareholders and other pass through business owners from 35 to more than 44 percent.

The resulting high rates drain working capital from these businesses. One of our members, McGregor Metal Working, testified back in 2015⁷ that prior to 2013 they were able to retain up to 66 cents of every dollar of after-tax earnings for working capital and hiring new workers. Post 2013, they only are able to retain up to 59 cents, a decrease of 16 percent in retained earnings potential. That is a huge reduction, and it means fewer jobs and less investment.

Pass Through Businesses and Tax Reform

Beginning in 2011, the Treasury Department began to push the idea of “corporate-only” tax reform. Under this plan, the business tax base would be broadened by eliminating certain deductions and tax credits with the resulting revenue used to pay for lower rates for C corporations.

The challenge this approach poses to pass through businesses is obvious. They use the same deductions and credits as C corporations, but unlike C corporations, their rates just went up, not down. The result would be pass through businesses paying top tax rates 15 to 20 percentage points higher than C corporations. This disparity would be simply unsustainable.

To assess how harmful this approach would be to pass through businesses, we asked Ernst & Young to study⁸ the effect of corporate-only tax reform. They found that corporate-only reform would increase the tax burden on pass through businesses by about \$27 billion per year. Industries most affected would include agriculture, construction, and retail.

Consider the impact on McGregor. The fiscal cliff raised their effective tax rate (including federal, state and local) from 34 to 41 percent. If Congress enacted corporate-only reform that lowered the corporate rate while eliminating McGregor’s access to LIFO, section 199, and the R&E tax credit, their effective rate would rise to over 50 percent.

No amount of small business expensing or cash accounting could help to offset that tax hit.

Pass Through Principles for Tax Reform

So the pass through community opposes corporate-only tax reform. What do we support? In 2016, more than one hundred trade groups, including the National Restaurant Association, the National Federation of Independent Business, and the American Farm Bureau, signed a letter articulating the following three principles for tax reform:

⁷ https://smallbusiness.house.gov/uploadedfiles/4-15-2015_mcgregor_testimony.pdf

⁸ EY reference



1. Reform needs to be comprehensive and improve the code for individuals, pass through businesses, and corporations alike;
2. Reform should reduce rates on individuals, pass through businesses, and corporations and seek to restore the rate parity that existed from 2003 to 2013; and
3. Reform should continue to reduce or eliminate the double tax on corporate income.

The difference between a “corporate only” approach that treats pass through businesses as an afterthought and true comprehensive reform that treats them as equal partners is rate reduction. Tax reform needs to reduce rates on corporations and pass through businesses alike and seek to restore the rate parity that existed prior to 2013.

Capping Pass Through Rates

One option to achieve this parity is to create a special, lower rate for pass through businesses. The House “Blueprint”, the plan outlined by Senators Rubio (R-FL) and Lee (R-UT), and the Administration’s tax reform outline all call for a new, lower top pass through rate. But separating pass through business and individual rates brings its own challenges – defining the new pass through tax base and including enforcement provisions to prevent cheating.

For the first, the tax base for pass through businesses should mirror the tax base for corporations and include all the active business income earned by S corporations and other pass through businesses. Provisions to limit the new rate’s application based on shareholder status or the size of the business are inappropriate. Senators Susan Collins (R-ME) and Ben Nelson (D-FL), along with Representative Vern Buchanan (R-FL), have introduced legislation that demonstrates how the pass through tax base can be defined effectively.

For the second, establishing a separate rate for pass through business income creates an enforcement challenge by taxing active pass through business income at a lower rate than individual wage and salary income. The bigger the difference in rates, the bigger the enforcement challenge.

In addressing this challenge, Congress needs to make sure it doesn’t undermine the value of the lower rate to business owners. Separating the return on owner’s labor from the return on their investment in the business is not easy, but guidelines to reinforce the new pass through rate should include:

1. Exempting non-active owners from the enforcement provisions. If an owner of a pass through business does not materially participate in the operation of the business, then there is no issue.
2. Recognizing the investment pass through businesses make in their capital and employees. The new rule needs to recognize that some businesses make significant



investments in both capital and employees and that much of the business' profits derive from these investments.

3. Ensuring the new rules are easier to comply with -- and enforce -- than the existing "reasonable compensation" rules the IRS uses today.

S Corporation Modernization

Beyond tax reform and rate reduction, there are other ways Congress can encourage the creation and growth of Main Street businesses. Since its inception, the S Corporation Association has promoted legislation to improve the rules that govern S corporations, some of which date back over half a century. This Congress, the S Corporation Modernization Act (H.R. 1696 and S. 711) was sponsored by Senators Thune (R-SD) and Cardin (D-MD) and Representatives Reichert (R-WA) and Kind (D-WI).

Key provisions in the bill would enable S corporations to attract foreign investment, reduce the bite of the so-called "Sting Tax" on excessive passive income, and ensure that S corporation assets passed on from one generation to the next are treated similarly to assets held by a partnership. The S Corporation Association is working with our sponsors to include these provisions in the tax reform legislation to be considered by Congress later this year.

Withdraw Section 2704 Rule

Finally, not all tax issues critical to S corporations fit under the umbrella of tax reform. Last August, the Treasury Department proposed changes to Section 2704 that would, if left intact, result in increased estate and gift tax valuations of family-controlled businesses of 30 percent or more.

The S Corporation Association has vigorously opposed these rules since their publication, submitting extensive comments, speaking at the public IRS hearing held in December, and organizing a trade association letter to congressional leadership requesting their assistance in defeating the rules.

Most recently, we released a critical study sponsored by the S Corporation Association and several other trade groups. Authored by Clinton Administration economist Robert Shapiro, the study quantifies the economic harm the pending rules would have on employment and economic output. As the study concludes, over the next decade the rule would:

- Reduce GDP by \$154 billion; and
- Reduce employment by 105,990 jobs.

The Trump Administration supports estate tax repeal and has asked Treasury to list out those existing and pending regulations that should be repealed or, in the case of pending rules,



withdrawn. The S Corporation Association has encouraged Treasury to include the 2704 rules on that list and intends to continue to press this issue until they are withdrawn.

Conclusion

Constructed correctly, tax reform can literally take us from one of the worst tax codes in the world to one of the best, but only if Congress pursues permanent, comprehensive reform that builds on the remarkable success of the S corporation.

By adopting reforms that conform to the three pass through principles articulated above, Congress can completely redo how we tax business activity in the United States, helping to ensure that all businesses, public and private, large and small, are able to compete and grow on a level playing field.

In turn, those businesses and the people who run them will respond with more investment, more jobs, and higher wages than if Congress did nothing. Tax reform is a generational opportunity, and like the S corporation, it needs to start on Main Street.

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Employment by Business Form and State (2014)

State	C Corporations		Pass-Through Businesses		Sole Proprietorships		Partnerships		S Corporations	
	Share	Employment	Share	Employment	Share	Employment	Share	Employment	Share	Employment
Alabama	42.1%	728,300	57.9%	1,003,534	20.0%	347,124	11.3%	194,876	26.7%	461,534
Alaska	40.3%	114,853	59.7%	169,812	22.6%	64,441	10.9%	31,000	26.1%	74,371
Arizona	43.6%	1,062,382	56.4%	1,373,429	18.1%	440,937	13.9%	339,144	24.4%	593,348
Arkansas	43.2%	453,349	56.8%	596,660	19.5%	204,844	11.4%	119,401	25.9%	272,415
California	43.1%	6,600,068	56.9%	8,729,622	22.2%	3,406,213	10.4%	1,591,356	24.3%	3,732,053
Colorado	40.5%	969,705	59.5%	1,422,209	18.7%	447,853	13.9%	332,792	26.8%	641,564
Connecticut	43.7%	643,274	56.3%	828,756	20.9%	307,921	16.1%	237,400	19.3%	283,435
Delaware	49.1%	195,702	50.9%	203,009	13.7%	54,655	14.7%	58,509	22.5%	89,845
District of Colu	43.9%	161,660	56.1%	206,418	17.0%	62,430	22.6%	83,082	16.5%	60,906
Florida	41.2%	3,557,508	58.8%	5,082,343	20.1%	1,739,731	10.4%	901,517	28.3%	2,441,095
Georgia	42.7%	1,707,995	57.3%	2,295,527	21.6%	865,048	10.5%	421,969	25.2%	1,008,510
Hawaii	50.1%	272,212	49.9%	271,486	21.0%	114,377	10.5%	57,021	18.4%	100,088
Idaho	34.6%	202,031	65.4%	381,233	21.0%	122,439	15.4%	89,817	29.0%	168,977
Illinois	44.3%	2,436,213	55.7%	3,068,390	17.5%	963,753	10.6%	581,334	27.7%	1,523,303
Indiana	40.3%	1,056,015	59.7%	1,565,634	16.4%	431,261	12.6%	331,351	30.6%	803,022
Iowa	45.1%	577,921	54.9%	704,151	17.4%	222,456	9.5%	122,062	28.1%	359,633
Kansas	45.1%	539,954	54.9%	656,641	17.9%	214,777	11.8%	140,886	25.2%	300,978
Kentucky	43.6%	694,931	56.4%	897,393	19.2%	305,141	12.2%	194,488	25.0%	397,764
Louisiana	38.3%	710,963	61.7%	1,143,685	20.5%	380,761	14.9%	276,817	26.2%	486,107
Maine	35.2%	174,319	64.8%	320,459	24.3%	120,135	9.6%	47,503	30.9%	152,821
Maryland	40.8%	947,363	59.2%	1,374,460	21.2%	492,043	11.4%	265,562	26.6%	616,855
Massachusetts	45.0%	1,307,633	55.0%	1,595,143	18.5%	537,166	10.5%	304,834	25.9%	753,143
Michigan	42.5%	1,551,151	57.5%	2,101,314	16.4%	599,519	13.0%	474,439	28.1%	1,027,356
Minnesota	42.3%	1,042,923	57.7%	1,424,426	17.1%	421,802	9.4%	231,374	31.3%	771,250
Mississippi	41.9%	412,954	58.1%	572,713	23.4%	230,761	11.9%	117,517	22.8%	224,435
Missouri	44.7%	1,075,740	55.3%	1,333,424	18.6%	448,452	11.1%	266,543	25.7%	618,429
Montana	31.4%	119,781	68.6%	262,148	22.9%	87,424	12.0%	45,757	33.8%	128,967
Nebraska	40.7%	345,809	59.3%	504,854	16.2%	137,454	9.4%	80,119	33.8%	287,281
Nevada	44.4%	550,067	55.6%	688,633	17.5%	216,355	15.6%	192,972	22.5%	279,306
New Hampshire	41.0%	233,811	59.0%	335,830	21.4%	121,836	11.6%	66,017	26.0%	147,977
New Jersey	41.7%	1,561,231	58.3%	2,181,255	18.3%	686,265	15.8%	593,047	24.1%	901,943
New Mexico	39.8%	254,204	60.2%	384,459	21.1%	135,060	13.9%	88,465	25.2%	160,934
New York	39.4%	3,101,935	60.6%	4,762,703	21.0%	1,648,990	13.8%	1,085,864	25.8%	2,027,849
North Carolina	44.7%	1,682,836	55.3%	2,084,595	19.6%	739,213	9.8%	370,051	25.9%	975,331
North Dakota	38.0%	127,520	62.0%	208,473	17.1%	57,442	11.1%	37,157	33.9%	113,874
Ohio	44.5%	2,074,729	55.5%	2,590,348	18.0%	841,177	11.8%	548,201	25.7%	1,200,970
Oklahoma	40.4%	589,800	59.6%	868,975	20.1%	293,582	14.3%	208,895	25.1%	366,498
Oregon	40.0%	594,809	60.0%	893,557	20.0%	297,526	12.1%	180,411	27.9%	415,620
Pennsylvania	43.2%	2,167,764	56.8%	2,855,287	18.2%	913,043	11.3%	565,105	27.4%	1,377,139
Rhode Island	37.3%	151,488	62.7%	254,172	18.8%	76,184	9.6%	38,964	34.3%	139,024
South Carolina	43.6%	766,549	56.4%	989,824	19.4%	341,492	11.3%	198,321	25.6%	450,011
South Dakota	33.7%	112,436	66.3%	221,168	20.2%	67,386	12.2%	40,623	33.9%	113,159
Tennessee	46.8%	1,224,105	53.2%	1,391,440	21.9%	573,331	16.4%	429,666	14.9%	388,443
Texas	44.4%	4,954,767	55.6%	6,197,271	21.1%	2,357,804	15.4%	1,717,186	19.0%	2,122,281
Utah	41.0%	502,640	59.0%	722,886	15.3%	187,055	15.7%	191,879	28.1%	343,952
Vermont	34.8%	90,263	65.2%	168,826	27.2%	70,585	9.3%	24,212	28.6%	74,029
Virginia	44.5%	1,477,090	55.5%	1,840,105	17.9%	593,351	11.1%	367,790	26.5%	878,964
Washington	43.0%	1,109,811	57.0%	1,470,607	18.5%	477,960	11.6%	298,092	26.9%	694,555
West Virginia	46.2%	258,872	53.8%	301,326	19.5%	109,046	12.7%	71,038	21.6%	121,242
Wisconsin	42.1%	998,866	57.9%	1,374,710	16.4%	390,412	10.1%	238,566	31.4%	745,732
Wyoming	36.9%	88,775	63.1%	152,126	19.0%	45,798	13.8%	33,157	30.4%	73,171

Source: Tax Foundation calculations based on Census County Business Patterns (2014) and Non-Employer Statistics (2014)

Note: Due to data constraints, some employees may be counted more than once



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Combined Top Marginal Tax Rate on Pass-through Businesses by State, 2016			
State	Sole Proprietors and General	Active S Corporation	Passive S Corporation Shareholders
Alabama	45.62%	42.64%	46.44%
Alaska	42.58%	39.60%	43.40%
Arizona	46.51%	43.53%	47.33%
Arkansas	47.93%	44.96%	48.76%
California	51.80%	48.82%	52.62%
Colorado	46.56%	43.58%	47.38%
Connecticut	47.93%	44.96%	48.76%
Delaware	47.80%	44.83%	48.63%
District of Columbia	49.17%	46.19%	49.99%
Florida	42.58%	39.60%	43.40%
Georgia	47.39%	44.41%	48.21%
Hawaii	48.75%	45.77%	49.57%
Idaho	48.24%	45.26%	49.06%
Illinois	46.03%	43.05%	46.85%
Indiana	45.97%	42.99%	46.79%
Iowa	47.08%	44.10%	47.90%
Kansas	42.58%	39.60%	43.40%
Kentucky	47.79%	44.81%	48.61%
Louisiana	45.96%	42.98%	46.78%
Maine	48.09%	45.11%	48.91%
Maryland	48.06%	45.08%	48.88%
Massachusetts	46.85%	43.87%	47.67%
Michigan	46.40%	43.42%	47.22%
Minnesota	49.72%	46.74%	50.54%
Mississippi	46.79%	43.81%	47.61%
Missouri	47.46%	44.48%	48.28%
Montana	47.93%	44.96%	48.76%
Nebraska	47.90%	44.92%	48.72%
Nevada	42.58%	39.60%	43.40%
New Hampshire	42.58%	39.60%	43.40%
New Jersey	49.18%	46.21%	50.01%
New Mexico	46.73%	43.75%	47.55%
New York	49.55%	46.57%	50.37%
North Carolina	47.24%	44.26%	48.06%
North Dakota	45.71%	42.73%	46.53%
Ohio	47.25%	44.28%	48.08%
Oklahoma	46.94%	43.96%	47.76%
Oregon	49.75%	46.77%	50.57%
Pennsylvania	46.04%	43.07%	46.87%
Rhode Island	47.38%	44.41%	48.21%
South Carolina	48.00%	45.02%	48.82%
South Dakota	42.58%	39.60%	43.40%
Tennessee	42.58%	39.60%	43.40%
Texas	42.58%	39.60%	43.40%
Utah	46.79%	43.81%	47.61%
Vermont	49.17%	46.19%	49.99%
Virginia	47.24%	44.26%	48.06%
Washington	42.58%	39.60%	43.40%
West Virginia	47.69%	44.71%	48.51%
Wisconsin	48.39%	45.41%	49.21%
Wyoming	42.58%	39.60%	43.40%
U.S. Average	47.13%	44.15%	47.95%
Note: Many states also apply gross receipts, margin, and franchise taxes to pass-through business income. In addition, some states			
Source: Tax Foundation			

Chairman RISCH. Thank you very much.
Mr. Mazur.

**TESTIMONY OF MARK J. MAZUR, DIRECTOR, URBAN-
BROOKINGS TAX POLICY CENTER**

Mr. MAZUR. Thank you, Chairman Risch, Ranking Member Shaheen, members of the Committee. Thank you for inviting me here today to discuss tax reform in small business. I just want to emphasize that the views I express are my own and should not be attributed to Tax Policy Center, the Urban Institute, their boards, or their funders.

There is broad consensus that the current system for taxing businesses is in dire need of reform. The U.S. tax system was last overhauled in 1986, and the current system, especially as it applies to business income, is woefully out of date. Three decades of changing business practices, increased globalization, and expanding aggressiveness of tax planning activities have led to the current situation.

If you look at the U.S. tax system, it is characterized by high statutory marginal tax rates for corporations; a large number of special tax provisions in the code that ensure most businesses do not pay at that top rate, incentives for multinational firms, both U.S.-based and foreign-based, to locate deductions in the United States, and locate income in lower-tax jurisdictions; incentives for certain firms to organize as pass-throughs and to escape corporate-level taxation; and substantial complexity throughout the tax system to the point where some taxpayers cannot even understand what their obligations are. Tax reform should seek to address some or all of these issues related to business taxation.

Tax policies we think of as guided by three basic notions: efficiency, equity, and simplicity. Efficiency means the tax system that raises the appropriate amount of revenue with as little economic distortion as possible. It is often characterized as relatively low tax rates, broad tax base, a portfolio of revenue sources, and a deep understanding of the incentives that are associated with the tax system.

Equity, the second principle, has two components: horizontal equity, treating similarly situated taxpayers in a similar manner, and vertical equity, that taxpayers who have a greater ability to pay taxes should shoulder a larger share of the provision of public services.

And the third component, simplicity, is important because if the tax code is too complex, taxpayers cannot understand their obligations, cannot comply with the tax law.

A lot of complexity just reflects our complex economic system. There are an infinite number of transactions people in businesses can enter into. But another large part represents the decisions, deliberate decisions, to run substantial portions of our social policy through the tax code, and each of those brings in their own set of qualifications and rules and so on.

An important thing to keep in mind is all three of these principles matter, and all come into play when you are designing tax policy, and really the art of policymaking is figuring out the right balance between these principles.

What I want to do is turn to just a few facts on businesses. As pointed out by some of the other witnesses, business can be organized by sole proprietorships, partnerships, limited liability companies, traditional C corporations, or S corporations. The traditional C corporation is subject to a separate level of tax, so two levels of tax, one at the entity level, one when those earnings are passed on to the owner. All the other types are pass-through businesses, where the income or loss is passed through to the tax return of the owners. All these business types can be small, large, or very large.

The most prevalent form of business is sole proprietorship. That is responsible for the largest number of returns of businesses. However, it is responsible for the smallest fraction of business activity. One thing to keep in mind is the largest share of this activity is attributable to traditional C corporations. So an important takeaway here is most businesses are small, most business activity, whether in corporate form or pass-through form, is in big businesses.

It is not the case that pass-through businesses equal small businesses, and that is one takeaway that you all should get from today. There are many types of large pass-through businesses, well-known companies, pipelines, accounting firms, law firms, that engage as pass-through businesses and are not really a small business.

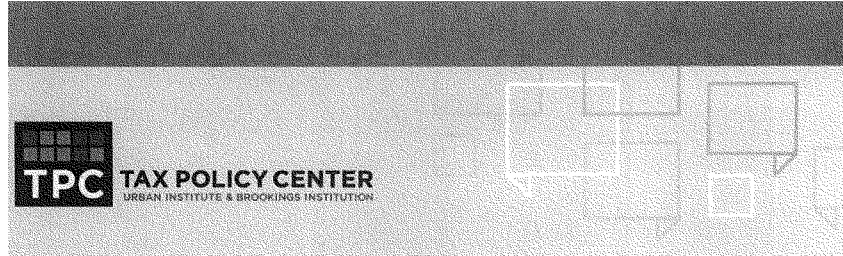
When we look at who owns pass-through businesses, we see a similar fact. Most pass-through businesses are small, owned by taxpayers of modest means, but the largest and most profitable are owned by very high income tax payers, and just one takeaway here is about two-thirds of the income of S corporations and partnerships accrues to the top 1 percent of the income distribution. So a tax cut for large pass-throughs is a tax cut for the top 1 percent.

And a final point I want to make today is when you look at base broadening as part of tax reform, that affects both the tax base of corporate taxpayers, traditional corporate taxpayers, and pass-throughs. And so it is a difficult balancing act to say what are we going to do if we broaden the tax base, lower the corporate rate, what happens to pass-through businesses compared to today? Left untouched, they would have a slightly higher, or a larger tax burden.

However, there are some specific steps you can take, and Ms. Nellen referred to a couple of these, that would provide simplicity for smaller businesses and lower their tax burden essentially giving you a double benefit for smaller businesses, and these are things like expanded cash accounting and expanded expensing.

I want to thank you all for your attention today. I would be happy to take your questions.

[The prepared statement of Mr. Mazur follows:]



Options for Small Business Tax Reform

Mark J. Mazur *

Robert C. Pozen Director of the Urban-Brookings Tax Policy Center

Before the
Committee on Small Business,
United States Senate

TAX REFORM: REMOVING BARRIERS TO SMALL BUSINESS GROWTH

Wednesday, June 14, 2017

Chairman Risch, Ranking Member Shaheen, and Members of the Committee, thank you for inviting me to appear today to discuss the impact of the tax system on small business and options for reform. The views I express are my own and should not be attributed to the Tax Policy Center, the Urban Institute, their boards, or their funders.

There is a broad consensus that the current system for taxing businesses is in dire need of reform. The US tax system was last overhauled in 1986, and the current system, especially as it applies to business income, is woefully out of date. Three decades of changing business practices, increased globalization, and expanding aggressiveness in tax planning activities have led us to a situation where we have very many critics of the current business tax system and precious few defenders.

* The views expressed are my own and should not be attributed to the Tax Policy Center or to the Urban Institute, its trustees, or its funders. I thank Len Burman, Bob Williams, James Nunns, and Joseph Rosenberg for helpful comments and Fiona Blackshaw and Yifan Zhang for help in preparing this testimony.

Mark J. Mazur, Robert C. Pozen Director, Urban-Brookings Tax Policy Center

Complaints about the business tax system include a maximum statutory corporate income tax rate that is among the highest in the world; a large array of special tax provisions that permits many firm to pay an effective tax rate far below the statutory rate; incentives for US-based multinational firms to shift profits abroad and to claim they are permanently reinvested there; an incentive for multinational firms (both domestic and foreign-parented) to locate deductions in the United States and income in lower-taxed jurisdictions; incentives for certain firms to organize as pass-through entities in order to avoid corporate-level taxation; and immense amounts of complexity that make compliance difficult and raise questions about the tax system's administrability and fairness.

Tax reform should address some of or all these complaints. Ideally, it would do so without creating offsetting problems elsewhere that overshadow any progress made in the name of reform.

My testimony today has four parts:

1. a review of the principles of tax policy, to provide a set of agreed-upon goals to guide any reform effort;
2. some basic findings about businesses in the United States to ground the tax reform discussion in fact;
3. a discussion of how the tax system affects smaller businesses and how a tax reform effort may affect them; and
4. a summary of several specific tax reform proposals that are intended to ensure that smaller businesses are not inappropriately disadvantaged by efforts at broader tax reform.

Tax policy is guided by three basic notions: efficiency, equity, and simplicity. An ideal tax system would advance all three goals to some extent, while recognizing that sometimes the goals conflict. Similarly, a tax reform effort would acknowledge that all three goals are important but would manage trade-offs among them.

An efficient tax system would distort economic choices as little as possible while raising the appropriate amount of revenue. Typical characteristics of an efficient tax system are relatively low tax rates, broad bases for taxation, a portfolio of different types of taxes to limit reliance on specific revenue sources, and an understanding of the incentives provided by the tax system so that policymakers minimize the enticements for taxpayers to reduce their tax bill through otherwise uneconomic actions.

Equity, as applied in tax policy, has two components: horizontal and vertical. Horizontal equity means that taxpayers in similar economic circumstance are treated similarly. In income taxation, this usually boils down to treating taxpayers with equal incomes equally. Strictly speaking, this would mean that the source of income would be disregarded in determining tax treatment and, ultimately, tax liability. Vertical equity means that tax liability should be distributed in accordance with the ability to pay taxes. That implies that those with larger incomes have a greater ability to pay taxes and therefore should shoulder a larger than proportionate share of the cost of public goods and services. This concept is associated with a progressive tax system, where the average tax rate paid (or average effective tax burden) goes up with a taxpayer's incomes. As a concept, vertical equity makes more sense when applied to the individual income tax or to the entire tax system than when applied to the corporate income tax. The US federal individual income tax is progressive throughout almost the entire income distribution. The overall US tax system is similarly progressive.¹

Simplicity is the third principle of desirable tax policy. One way to promote simplicity is to reduce the compliance burden that the tax system imposes. The Internal Revenue Service (IRS) regularly assesses the overall burden of the US tax system by the number of hours required to understand one's tax obligations, keep appropriate records, file the necessary tax forms, and interact with the IRS after filing. Individual taxpayers spend around 2 billion hours a year complying with the individual income tax, and the cost to businesses is estimated to run to over \$100 billion annually.

But beyond the hours and dollars, there is a sense among taxpayers and tax policy observers that the tax code is too complex for ordinary Americans to understand their tax obligations and comply with them. This sense of extreme complexity is evidenced by the robust tax preparation and tax software industries, as well as a sense among taxpayers that they are missing out on benefits being claimed by others. A lot of the existing complexity merely reflects the increasingly complex world in which we live. Individuals and businesses can enter into a nearly limitless number of possible economic transactions. These possibilities reflect economic and social complexity, globalization, and long-standing efforts at financial engineering. Congress, however, is complicit in this sense of growing complexity; the past three decades have been characterized by increasing amounts of social policy being run through the tax code. While this can be an efficient method of delivering benefits to particular taxpayers, every one of these provisions carries with it eligibility rules and benefit calculations that can overwhelm taxpayers. This proliferation of tax expenditures itself fosters complexity.

But tax incentives should not be avoided simply because they lead to complexity. In some instances, overriding public policy considerations argue for deviating from one or more of the

¹ See, for example, the Tax Policy Center's model estimate of average effective federal tax rates at <http://www.taxpolicycenter.org/model-estimates/baseline-average-effective-tax-rates-march-2017/t17-0042-average-effective-federal>.

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three major tax policy principles. For example, our economic system by itself may lead to an insufficient amount of activities with important spillover benefits (such as basic research) or to over-consumption (or provision) of some activities with negative spillover benefits (like tobacco or alcohol consumption). In these cases, specific provisions in the tax code (such as the research and experimentation tax credit or excise taxes on alcohol or tobacco purchases) can address under- or over-supply.

It is important to be aware of the trade-offs among tax policy principles. An optimal system will seek to balance out the contributions of each dimension and carefully weigh deviations. When Congress enacted the 1986 Tax Reform Act, it devoted much time and energy and debate to considering the degree to pursue each of these desirable traits in the legislation. Given three decades of incrementally moving away from the 1986 agreement on each of these policy goals, it is time to refocus attention on designing a tax system that meets them to the maximum extent possible.

FACTS ON BUSINESSES

The taxation of business largely depends on the choice of organizational entity for the business. A business can be owned by one person and operated as a sole proprietorship, with all the net profits or losses passing through to the owner. A business can be established as a partnership of two or more people or entities. Partnership agreements can be flexible about the share of profits or loss and the source of those flows that goes to each partner. The tax consequences of the businesses activities of the partnership pass through to the partners in accordance with the partnership agreement.

Limited liability companies (LLCs) are a relatively recent phenomenon, where the members/owners of the company can elect to be treated as a partnership or as a traditional corporation for income tax purposes. But the members/owners can still benefit from the limited liability they receive from a traditional corporation without paying a separate corporate income tax. If members/owners elect to treat the LLC as a partnership, then the net profits and losses of the entity and their character, are passed through to the owners in accordance with the legal agreement establishing the LLC.

A traditional corporation, often called a C corporation (after the section of the tax code that governs it) pays an entity-level tax each year on its net profits. Distributions to the corporation owners in the form of dividends are taxed at the shareholder level. Thus, there is the potential for a second layer of taxation—one at the entity level and another at the shareholder level—on the income earned by a traditional corporation. A special category of corporation, called an S corporation (again, after the relevant section of the tax code) does not pay tax on net income at the entity level. Like partnerships, the net profits and losses are passed through to the owners. But, unlike a partnership, which may allocate profits according to any agreed-upon

formula, the pass-through amounts in an S corporation must be proportional to ownership shares. S corporations also have limits on the total number of shareholders, placing a limit of the use of this form of entity.

Owners of pass-through businesses are taxed more favorably than owners of traditional C corporations because they pay only the individual income tax on business earnings, while the profits of C corporations are taxed at the corporate level and then again at the individual level when paid out as dividends or realized as capital gains. For example, consider a business owner in the top individual income tax bracket receiving net taxable profits of \$1 million from ownership shares of an S corporation. This owner would report \$1 million of business income and pay a tax of \$396,000 at the top individual tax rate of 39.6 percent. There would be no additional income tax if the S corporation distributes some of its earnings to the owner. Now consider a similar owner of a traditional C corporation, also with \$1 million in net taxable profits. At the current corporate income tax rate of 35 percent, the corporation would pay \$350,000 in income tax. If the remaining \$650,000 is distributed to the owner as a dividend, it would be subject to individual income tax at a maximum rate of 23.8 percent, for an additional liability of \$154,700. This puts the total income tax payments related to the original \$1 million in business income at \$504,700. This additional tax liability may provide a disincentive for the traditional C corporation form, affecting the choice of entity by individuals who are forming businesses.

Most business returns are sole proprietorships, followed by S corporations, partnerships (including most LLCs that elect to be treated as partnerships), and traditional corporations. While most businesses are pass-through entities, most economic activity (though a declining share) is associated with traditional C corporations, where it is subject to an entity-level tax (table 1).

TABLE 1

Distribution of Returns Filed And Business Receipts by Business Return Type, 2014



	C Corporations	Partnerships	S Corporations	Sole Proprietorships	Total
Number of returns (in millions)	1.6	3.6	4.4	24.6	34.2
Business receipts (in trillions of dollars)	20.1	5.3	7.2	1.4	34.0
Share of returns	4.7%	10.5%	12.9%	71.9%	100.0%
Share of business receipts	59.3%	15.6%	21.2%	4.1%	100.0%

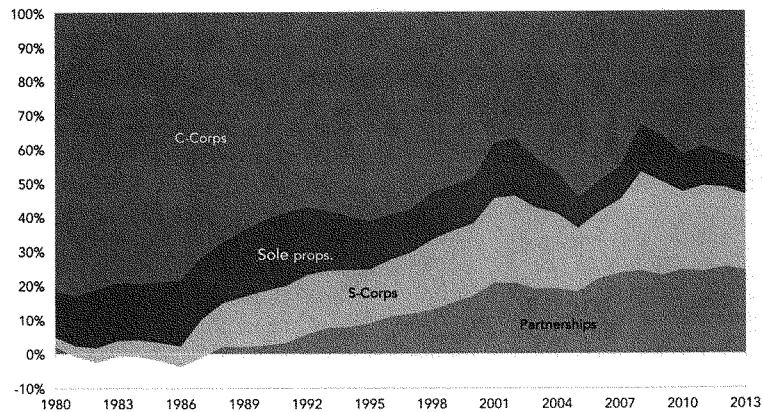
Source: Prinszano et al. (2016, Table 1).

This situation has changed somewhat over time: the composition of business income has changed over the past few decades, with the dominance of traditional C corporations declining since 1980 (figure 1). This shift reflects several factors: shifts in tax rates for individuals and corporations that affect the desirability of organizing as a traditional C corporation; tax law loosening the ownership limits of S corporations; state law changes accelerating the adoption of

Mark J. Mazur, Robert C. Pozen Director, Urban-Brookings Tax Policy Center

LLCs; and greater acceptance by individual taxpayers of the complexities associated with investments in pass-through entities.

Figure 1
Share of Total Business Net Income (less deficit)
1980 - 2013



Source: Nelson (2016).

Note: Shares do not include regulated investment corporations (RICs) and real estate investment trusts (REITs). C- and S-corporation income includes officer compensation.

Each type of business entity—sole proprietorship, partnership, LLC, S corporation, and traditional C corporation—can be almost any size. But the distribution of businesses by type, like many other distributions in economics, has a large fraction of small entities carrying out relatively small amounts of activity, with the bulk of the economic activity carried out by a relatively small number of the very largest enterprises.

The largest number of entities are in the smallest size categories, but the bulk of total economic activity is accounted for by the relatively small number of the largest entities (table 2). While most businesses are small (including pass-through businesses), it is incorrect to equate small business with pass-through business. In fact, many large pass-through businesses are major players in such industries as accounting, law, financial management, natural resources, pipelines, and real estate.

TABLE 2

Distribution of Partnerships, S Corporations, and C Corporations Returns, Business Receipts, and Net Income by Asset Size (in percent), 2013



	\$100,000 or less	\$100,000 to \$1 million	\$1 million to \$10 million	\$10 million to \$50 million	\$50 million or more
Partnerships					
Returns	46.1%	28.9%	20.5%	3.3%	1.2%
Business receipts	6.6%	7.1%	13.0%	13.1%	60.1%
Net business income*	7.2%	5.7%	11.2%	9.3%	66.6%
S Corporations					
Returns	63.3%	28.5%	7.2%	0.8%	0.2%
Business receipts	9.3%	19.2%	27.2%	20.9%	23.4%
Net business income*	16.4%	21.5%	23.7%	15.7%	22.7%
C Corporations					
	\$1 million or less	\$1 million to \$10 million	\$10 million to \$50 million	\$50 million or more	
Returns	95.8%	3.1%	0.6%	0.5%	
Business receipts	10.9%	10.2%	8.3%	70.6%	
Net business income*	25.0%	-4.5%	-3.3%	82.8%	

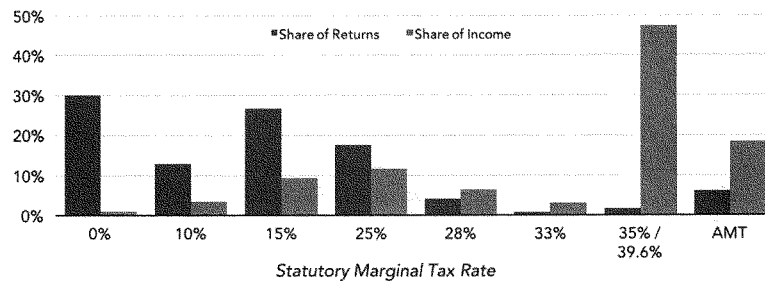
Source: Internal Revenue Service, Statistics of Income, at <http://www.irs.gov/uac/SOI-Tax-Stats-Partnership-Data-by-Size-of-Total-Assets>; <http://www.irs.gov/uac/SOI-Tax-Stats-Nonfarm-Sole-Proprietorship-Statistics>; <http://www.irs.gov/uac/SOI-Tax-Stats-Corporation-Source-Book>.
 Notes: *Equals net profits for firms with positive profits minus net losses for firms with losses.

Other important facts are who ultimately owns pass-through businesses and the marginal tax rates faced by these owners. In a technical report published last year, the Office of Tax Analysis in the Department of Treasury found that most tax returns with pass-through income are filed by individuals with a marginal tax rate of 15 percent or lower (figure 2). But the vast majority of income is reported by those in the highest income tax brackets (35 percent, or 39.6 percent subject to the alternative minimum tax). In fact, among firms with pass-through income, the 3 percent of individual income tax filers in the 35 percent or 39.6 percent tax brackets receive 51 percent of the total income from all pass-through entities. So, pass-through income is highly concentrated at the top of the income distribution. The degree of concentration is illustrated by the fact that over two-thirds of the total amount of S corporation and partnership income accrues to the 1 percent of taxpayers with the highest incomes.

Mark J. Mazur, Robert C. Pozen Director, Urban-Brookings Tax Policy Center

FIGURE 2

Pass-Through Income by Statutory Marginal Tax Rate



Source: Prisinzano et al. (2016, Table 10).

Note: Includes income or loss from Sch. C, Sch. F, and Sch. E rental, partnership, and S-corp income.

HOW TAX REFORM CAN AFFECT SMALL BUSINESS

Traditional tax reform broadens the tax base, which expands taxable income and allows for lowering the statutory tax rates on that income without losing revenue. The 1986 Tax Reform Act, for example, broadened the income tax base enough to support a revenue-neutral reduction in the corporate income tax rate from 46 percent to 34 percent and a reduction in the top individual income tax rate from 50 percent to 28 percent. Even though more income (and more business income) was subject to tax, the related tax rates were dropped substantially.

With business tax reform, many base-broadening proposals would increase the size of the tax base across the board: for small and large businesses and for traditional C corporations and pass-through entities. This might disadvantage smaller C corporations unless the tax rates applied to lower-income corporations (already below the statutory maximum) also were reduced. Such a reform also would certainly broaden the tax base for pass-through businesses. These entities could see an increase in tax liability for their owners, unless individual income tax rates were also correspondingly reduced.

Policymakers would need to grapple with the issue to reach an accommodation, because this illustrates the trade-offs in designing tax policy. If the steps taken to broaden the tax base under reform more accurately measure income, then these changes should be encouraged as increasing horizontal equity between those who earn income from business activities and those who earn salary or wage income. Similarly, if the net effect of the base-broadening and lowering corporate tax rates is to decrease the tax advantage that pass-through entities have over traditional C corporations, then that also could be a positive step for economic efficiency. But if

these changes dissuade business formation by entrepreneurs or discourage innovative activities that have positive spillover effects, then there could be an offsetting effect.

It is important to focus on the innovation and business formation activities rather than on the size of the businesses involved. Small businesses have many attractive attributes for society, but the public policy focus on designing tax policy should be on aspects of the business activity that spill over to the larger community and are not perfectly captured by the business owners themselves. For instance, economic research has shown that innovation is often associated with new firms, which can drive industry-wide or economy-wide change, opening up new markets or unlocking efficiencies. Thus, there is a reasonable economic argument for encouraging new firms and start-up firms and individuals exploiting their entrepreneurial ideas. The current tax code does some of this, providing significant benefits to successful start-up entrepreneurs.²

APPROACHES TO SMALL BUSINESS TAXATION

In evaluating reforms, it is useful to consider the benefits that small businesses might obtain from specific proposals and then consider whether these benefits advance the tax policy goals of efficiency, equity, and simplicity. If the important public benefits of tax policy changes are associated with new forms that can drive innovation, then a few specific policies stand out as being supportive in this area.

Increased limits for start-up and organizational expenses can help businesses form and commence operations. These types of expenses generally are limited to new firms that are establishing themselves as operating entities. Under current law, an entity can immediately expense (deduct) up to \$5,000 in start-up expenses and another \$5,000 in organizational expenses. These amounts could be combined and the aggregate amount increased to provide a larger tax benefit for starting up a new business. This change could also provide some simplification by permitting an immediate deduction instead of amortization (cost recovery) over a period of years.

Under Section 179 of the tax code, a business may immediately expense up to \$500,000 of qualifying property and equipment each year. This immediately deductible amount is phased out if the amount of qualifying property placed in service exceeds \$2 million. So, this provision is targeted at smaller firms by design and encourages these firms to make capital investments that can embody the newest technology. Congress set the amount at \$500,000 (adjusted for inflation) in 2015, but a reexamination of this provision may be warranted, since it clearly simplifies the tax calculations for affected entities and could also help spur innovation. Calculating depreciation expenses and maintaining adjusted basis for assets owned are a source of significant complexity for small businesses.

² See, for example, Eric Toder, "Taxing Entrepreneurial Income" (Washington, DC: Tax Policy Center, 2017) at <http://www.taxpolicycenter.org/publications/taxing-entrepreneurial-income>.

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Smaller businesses often have a larger per-unit cost of complying with the tax code than larger businesses. One major area of complexity is accrual accounting, which often requires sophisticated financial skills. Under current law, businesses must undertake a series of calculations involving gross receipts, type of business activity, entity type, and sometimes ownership interests to determine whether they must use accrual accounting or if they are eligible for the simpler cash accounting method. These restrictions are meant to ensure some measure of horizontal equity for different types of taxpayers, but Congress may wish to review the various constraints to see if they still function as desired. One possible approach would be to set a dollar threshold where firms with smaller amounts of gross receipts could use a simplified method of cash accounting (similar to maintaining a checking account). This approach could simplify tax compliance for many smaller businesses at the cost of a loss of horizontal equity.

A final area for Congress to consider that relates to ease of tax compliance is the establishment of basic income reporting rules for payments between businesses. Congress has established thresholds for reporting miscellaneous income to individual recipients using Form 1099 and has established thresholds for debit and credit card reporting. Pushing a little further on information reporting could provide taxpayers (particularly entrepreneurs and smaller firms) with the information necessary to fulfill their tax compliance obligations at relatively low social cost (especially where electronic information already exists). And it would help improve horizontal equity by treating taxpayers with similar amounts of income similarly.

In the ongoing discussion of business tax reform, several proposals have been made to establish a special preferential tax rate for income from pass-through businesses. These proposals are often characterized as providing support for small businesses. However, as the basic facts on US businesses show, most small business owners pay income tax at a modest rate and so would not benefit from a reduction in the maximum tax rate applied to pass-through income. But most pass-through income accrues to individuals who are subject to the top individual income tax rates. That means providing a preferential pass-through business income tax rate would be expensive in terms of forgone revenue. And a preferential tax rate for this type of business income would create a huge tax wedge between income earned as salaries and wages and income classified as pass-through business income. By itself, this would exacerbate concerns about horizontal equity as people with similar overall incomes could be treated quite differently. But a large wedge between ordinary income tax rates and the new preferential tax rate on pass-through income would create a huge incentive for inappropriately characterizing ordinary income as lower-taxed pass-through income. This could add substantial amounts to the potential revenue cost.³

³ For a recent illustrative analysis, see Jeffrey Rohaly, Joseph Rosenberg, and Eric Toder, "Options to Reduce the Taxation of Pass-Through Income," (Washington, DC: Tax Policy Center, 2017), <http://www.taxpolicycenter.org/publications/options-reduce-taxation-pass-through-income>.

SUMMARY

In determining how to move ahead on tax reform, policymakers should be aware that reform can have disparate effects on different participants in the economy. The three guiding principles of tax policy—efficiency, equity, and simplicity—provide a framework for evaluating policy choices. And some facts about US businesses can help guide the ongoing tax reform discussions:

- most businesses are small (traditional corporations and pass-through businesses);
- most economic activity takes place in larger enterprises (traditional corporations and pass-through businesses);
- pass-through businesses overlap with, but are not identical to, small businesses; and
- most income from pass-through businesses accrues to individuals at the top of the income distribution.

These facts, combined with the tax policy principles articulated, can help inform the policy debate and evaluate policy alternatives.

Chairman RISCH. Thank you very much. Mr. Reardon—we will now have a round of questions. Mr. Reardon, you made a reference that I would like you to maybe put a little meat on the bones. You made reference to expense deductions and the limits on them that should be expanded, that is limits should be withdrawn or raised or something like that.

Mr. REARDON. Mm-hmm.

Chairman RISCH. Did I pick that up correctly?

Mr. REARDON. Yes.

Chairman RISCH. What were you referring to there? Could you do a—just—

Mr. REARDON. I think under current law, there is Section 179, which allows businesses to expense immediately capital investments up to a certain level.

Chairman RISCH. I see. Okay. So you are talking about capital expenditures.

Mr. REARDON. Capital expenditures.

Chairman RISCH. Okay.

Mr. REARDON. And most of the proposals that are out there would either increase that limit or simply move to pure expensing, so that, you know, if businesses invest in, you know, equipment, inventory, et cetera, they could write it off immediately. I think the House plan includes real estate and other things as well. So it is very dramatic in the ability of companies to write off immediately what they are investing in.

The Tax Foundation, just today, put a nice blog post up, talking about the economic benefit of that, and I think the Tax Foundation argues that moving towards expensing is actually more beneficial to the economy than a significant rate reduction in C corporations. It is pretty powerful stuff.

Chairman RISCH. And is that—is the advocacy for that small businesses as well as large businesses?

Mr. REARDON. So I used to work at the National Economic Council, back in 2003, when we were cutting taxes, and we went around the country talking to businesses, and that is when we were doing the 50 percent bonus depreciation in expanding the expensing opportunities for businesses. And what I found was that while most businesses would take expensing if they could get it, it is the non-public sector, it is the private companies that really seem to value it more, and I think that is because they do not have access to the capital markets, cash flow is much more of a challenge to smaller businesses than it is to larger businesses. And so the ability to go out and buy a piece of equipment, write it off immediately, start getting returns on that equipment before you have to start making, you know, real payments, real cash outlays, is a significant advantage to that.

Chairman RISCH. I understand the argument and I subscribe to that argument. I suspect somewhere along the way they are going to find some example that somebody that should be paying taxes will not be, because they are able to do this, perhaps even on an ongoing basis, and that will cause people's hair to catch on fire around here, has been my experience.

Mr. REARDON. Yeah, I think the House has run into that with the blueprint, where, you know, they are moving from an income

tax base to a cash flow tax base, and yet people in there are analyzing the plans to look at it as if it is income. Well, why are you not paying taxes if you have income? Well, it is a different base, and so you have to look at it differently.

Chairman RISCH. Thank you very much. Senator Shaheen.

Senator SHAHEEN. Thank you, Mr. Chairman, and thank you all for your thoughtful testimony.

I recently talked to New Hampshire Small Business Person of the Year, a man named Jake Reder, who is the CEO of Celdara Medical, which is an innovative biomedical company in Lebanon, New Hampshire, and right now Jake's firm pays Federal taxes but it also pays taxes in New Hampshire, Maryland, New York City, New York State, and Massachusetts. And Jake said, "This is not about paying less taxes. This is about spending less time and energy on taxes and knowing we are doing them right." I thought that was a very—that comment reflected what I hear from other small businesses.

So you all have suggested some ways that we might simplify the tax code. Can you also talk about how much of the burden on small businesses is the result of having to comply with multiple jurisdictions, and if there are any ways that we could encourage states and local governments to help small businesses with filing their taxes. As we think about what we need to do here, what else should we be looking at?

Chairman RISCH. Jump ball.

Ms. NELLEN. Okay. Thank you. You are getting at the point of certainty and people would like to have certainty, because having this sense of doubt, did I do it correctly, is costly in many ways, because you have the risk of error, plus sometimes you might not do a transaction because you might not feel confident you know what the answer is. So it can be costly in many ways.

As far as simplification, I think many things that AICPA has been promoting for some time, keeping and expanding the use of the cash method of accounting; expensing, so you do not need to keep records in expense, I think, as widely as you can. Yes, expensing does primarily benefit those with high capital needs, you know, equipment and all of that. We have a lot of service-based businesses today as well. But the simplification of the expensing, that would include the startup costs, organizational costs, an increasing of the 179. We know we just expense it. That makes it easy to not worry about how to classify for depreciation purposes. That all goes away.

Repeat of the AMT, because you are just doing extra calculations. There is extra record-keeping. You have separate record-keeping for, you know, any NOL you had, the passive activities, and just trying to explain to the small business owners, just trying to pay their taxes correctly, why they thought they were going to get a deduction for something, and then they did not because it is not allowed for AMT and they owe AMT. And obviously a lot of pass-throughs and sole proprietors are paying AMT and it is just a confusing state, and a lot of time involved in dealing with the AMT as well.

I think making sure there is sufficient guidance, you know, some way that, you know, we know that, you know, IRS the resources

to provide the guidance for items. We have actually seen that where, you know, changes come up and we actually sometimes saw the initial instruction from the IRS was actually in the instructions to the forms, when it really should be in regulations with public comment first, many times. So that can delay, and then you are asking your practitioner, "How do I use, for example, this credit—research credit against my payroll tax?" The practitioners, like we do not have all the guidance yet, yet it is time to file the return and take advantage of that.

Senator SHAHEEN. Right. And one of the things that we know is that the resources available to the IRS are significantly less than they were 10 or 20 years ago, in terms of the ability to respond to phone calls and to actually provide that kind of guidance.

Let me go to another question, because when we last updated the tax code in 1986, there were approximately 4 million women-owned businesses. Today there are more than 11.3 million women-owned businesses. They represent about 38 percent of all firms in this country. But there are institutional barriers, especially in our tax code, that really affect women-owned businesses.

There was a report that was done by the American University's Tax Policy Center, and it showed that Congress and the Administration do not have sufficient information about how the tax code treats women-owned firms in order to put in place reasonable policies that would encourage them to grow.

Can any of you comment on what you have seen in this area?

Mr. REARDON. Sure. I think it is part of the good-news story that we have seen since 1986. You know, the big reform in 1986 was that it brought down top rates on pass-through businesses, down to, and actually, at that time, below where the C corporate rate was, which is the reverse of where it was before. Prior to 1986, C corps paid significantly less, and most business activity was under the C corp structure, which was not a good thing because the C corp structure is not a very efficient structure with a double tax.

What it meant was that people would set up C corps, they would try to stick as much income as they possibly could in the C corps, and then they would try to figure out ways to get value of the C corp without having to pay the second layer of tax. There was a lot of gaming going on. And the beauty of the pass-through structure is that it eliminates that gaming. You know, you make money, you pay the tax when it is owed, and then that is it. You can do whatever you want with the earnings after that, and you do not have to worry about the tax consequences.

And the net result of that, we saw an explosion in the number of LLCs and in S corporations. It just made entrepreneurship easier, and which meant that you had an opportunity for, you know, people of all genders to go out and start businesses. It reduced the barrier to starting a business significantly, and the net result is you have a bigger business community today than you did back then.

Senator SHAHEEN. Well, except that one of the contentions in this report is that what we have in our current tax code are institutional barriers to those women-owned firms. So I do not know. Does any—Mr. Mazur.

Mr. MAZUR. I think this is just an area where additional research and work could be done. This is an area where I think—you mentioned the IRS has been under-funded. The IRS has an opportunity to do research on the tax information that there is and determine what the barriers are, and then essentially propose either legislative changes or administrative changes to address those barriers. But given kind of a lack of funding, that never gets to the top of the to-do list for the agency.

Senator SHAHEEN. Thank you all.

Chairman RISCH. Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman. Can you hear me okay?

Tell me—I want to talk about a solution in a second but first I am going to talk about the problem. How did we get the worst tax code in the world? Anybody.

Mr. REARDON. Well, I will start. By sitting still. Back in 1986, when we last reformed the code, we brought the corporate rate down from the high 40s down to 35 percent. At the time, that was one of the lower tax rates in the developed world. I think the average for the OECD at that time was about 44 percent. Today the average for the OECD is down in the low 20s, I believe. We are still at 35. So we have been—

Senator KENNEDY. Before or after the exemptions?

Mr. REARDON. Those are the marginal rates, but even when you look at effective tax rates, when you take those into account, we are still at the very high end of the worldwide average.

So we have been sitting still, both on rates and also this idea of, you know, there is this concept of, you know, now we have a worldwide tax system. We tax, you know, our businesses on their earnings wherever they are made. Most countries in the last 10, 15 years have moved to a territorial system. England did. You know, 10 years ago, England, the UK had the same problems we did. They had inversions. They had companies moving overseas. They were losing out to other countries, in terms of when companies were up for sale, or you had competition in markets.

They completely revamped their rates. They cut their rates down. They moved to territorial, and now companies are moving to the UK, not away from the UK. So we sat still; everybody else got busy reforming their tax code.

Ms. NELLEN. We also added more rules to the law since 1986, of multiple—added more rules, you know, multiple education provisions, just retirement plans, a child credit. So additional rules, we have to figure out what those mean, so that adds to the complexity as well.

Senator KENNEDY. Okay.

Mr. MAZUR. I just think one thing, as Brian mentioned, if you look at the 1986 Tax Reform Act, that was where the U.S. actually reformed its tax system and got to a reasonably good place. The 30 years since then, essentially, we have been going the wrong direction, adding a number of special interest provisions to the law that are complex, hard to navigate, and, as Brian pointed out, having—keeping our tax rate—corporate tax rate higher.

So instead of broadening the tax base and lowering the rate, we have been narrowing the tax base and keeping the rate higher, and

it just means that in a complex world where there is lots of globalization, companies and their advisors take advantage of many of these opportunities or mismatches, and it makes it incredibly complex for everybody to comply with.

Senator KENNEDY. Secretary Mnuchin testified the other day, in our Banking Committee, and I asked him what he thought about going to the companies overseas that have made money, but if they bring it back, under our—what I will call our non-territorial system of taxation—if they bring it back they have got to pay tax on it. I asked him what he thought about the idea of going to them and giving them an incentive, a lower tax to bring it back, and then using that money for infrastructure. He was polite but he did not seem to think that was too good of an idea.

I kind of like it. What do you think about it?

Mr. REARDON. I do not really get into the spending side of things. I am more on the tax side of things, so I will leave the—

Senator KENNEDY. Well, a tax exemption is an expenditure. You are aware of that.

Mr. REARDON. It is not collecting tax that you might otherwise receive. That is correct. But I am a big believer in the idea that, you know, until we take it from somebody it is their money, right?

Senator KENNEDY. I agree with you. Radical. Radical.

Mr. REARDON. Yeah. Radical. Yeah. You know, the first time we did repatriation was when I was at the NEC, and the White House was divided on it. I think, at the end, we did not support it. I personally, you know, I would much rather that the companies have full access to this money by bringing it back, you know, and you have to put air quotes around that because sometimes the money is right here in a U.S. bank. It is just not in the bank account of the parent rather than the subsidiary—and have full access to that, and be able to do whatever they want with it, and there is concern, well, maybe they will just pay dividends to their shareholders. Well, fine. They will give it to the shareholders and the shareholders put it in the bank, and then it is available to somebody else to do stuff with.

I do not have a problem with that, but I do know that, you know, we do need to eliminate the incentive for companies to make money overseas and then just sit on it overseas. It makes no sense. We need to move away from the worldwide system.

Chairman RISCH. I think the division has kind of disappeared here. Most people want to bring it back. The problem is, what do you do with it when you get here.

Senator KENNEDY. Yeah.

Chairman RISCH. As Senator Kennedy suggested, the people who want it for infrastructure are interested in that, but I have heard at least—that it has been spent six times and it has not even shown up yet.

Mr. REARDON. Yes. Right.

Chairman RISCH. I am sorry I cut into your time, Senator Kennedy. Go ahead. Senator Kennedy, you are still up.

Senator KENNEDY. I think I am over, Mr. Chairman. Thank you for your time.

Chairman RISCH. All right. Thank you. We appreciate it. Those are good thoughts.

Senator Booker.

Senator BOOKER. Thank you very much, Mr. Chairman. I am blessed to hold a seat from somebody that is kind of a political hero of mine, Bill Bradley, and I am really proud of the work he did in 1986. But since then, we have screwed things up, remarkably, and you all put it right. We have seen a lot of special interest groups come in here, narrowing our tax base, keeping it where it was, which is the highest corporate tax rate, as far as I know, on the planet Earth, and it is ridiculous. And you have some businesses paying extraordinary taxes, others who have had great lobbyists come down here and champion ways to create loopholes, have effective tax rates of zero.

And, you know, I, like many of my colleagues, have come from local government or being governors, where you do not have the privilege of doing the kind of games we play here. You have got to balance your budget every single year, and create reasonable tax policy.

And I represent, before I came to the Senate, a poor city, struggling, population was decreasing for 60 years, its tax base was disappearing. We had to figure out a way, through a storm, and effectively we were just as bankrupt as the Federal Government is, and we made tough decisions.

I actually challenge that. I wonder if my colleagues can beat this, but I do not think anybody in the United States Senate right now has cut government more than I had to do, the painful, gut-wrenching cuts, but we cut my government 25 percent, but we also strategically raised taxes.

I watched, in astonishment as the first time in the history of our Nation we went to an expensive war and we cut taxes at the same time, creating massive deficits. I could not understand why basic economics did not work here, that you have got to pay for what you do.

And so I think tax policy here has been screwy and the American people are paying for it, and we cannot compete now with our global competitors who make strategic investments that we do not make anymore. They are out-America-ing America.

If you look at the World Economic Forum, they said that this country was the best competitive democracy—we were the best leading up until recent time. We were the best in investing in our infrastructure. China and Europe outdo us now. We were the best in investing in education. Now other countries are outperforming us in education. We were the best investing in research and development. Heck, private sector gains in this country, just the device I am holding, all comes from battery life, touch screen, GPS, all from government strategic investments that fueled our economy.

And so it is outrageous to me that we still have philosophy controlling our government and our tax policy here, and not what actually works. And who is suffering from it? Small businesses in my city of Newark and my State.

And so, Mark—I have now lectured too long, but I would like for you to just respond to something to me that was a philosophy that was put in place that just did not work. I would like to submit, for the record, a New York Times article on the so-called Kansas Experiment, where you have folks with their philosophy coming in

and saying, "Let us cut all taxes." Massive tax cuts. The cumulative cut was \$3.9 billion, biggest of any State.

And I just want you to comment in the minute and a half I have left you, Mark, you know, when you have this—what was the result of this experiment, in terms of just—because I wish we could get back to a pragmatic, basic balance sheet analysis of how to run this country, because we are running it really irresponsible now, but how to create growth, how to create opportunity, how to create jobs. Can you talk about how the Kansas Experiment, based on philosophy, went tragically wrong, and your thoughts on it?

Mr. MAZUR. Sure. So I think just some of the facts on the Kansas Experiment. In 2012, Kansas reduced its individual tax rates across the board, but it reduced its taxes on pass-through businesses to zero, from 5 or 6 percent to zero. Predictably, what happened is you got more pass-through businesses, but you got way less in revenue, because ordinary taxpayers created a pass-through business to shelter some of their income. Whether you were an accountant or a sports coach, or whatever you could do, you would put your activity in a limited liability company and claim that you were tax exempt.

And so the situation in Kansas was you reduced a lot of the investments that they made, across the board in education, infrastructure, and so on, to the point where I think the Kansas citizens thought that was a bad tradeoff. They would prefer to have slightly higher taxes and better services—better education, better infrastructure, better health care, better public protection.

Senator BOOKER. So I will end with just this statement. But what I failed to mention was the growth of that statement.

Mr. MAZUR. Oh, if you compare to other states, neighboring states, Kansas is not as good as the neighboring states. So you have almost a natural experiment there.

Senator BOOKER. And so I am a pro-growth guy. I want this economy to grow, and I just want to point to Kansas as an example that we have to start thinking of a balance sheet analysis of our country—where we should be investing, how we should be doing this, to create growth, and a country that does not invest in infrastructure, that does not invest in science or technology, who does not invest in education, is not going to grow compared to what our competitor peers are doing. We have got to find the right balance. Taxes are too high—I will admit that—but we have got to find the right balance and focus on jobs, because that is what people want, at least my constituents in New Jersey. They want jobs, economic growth, and opportunity.

Thank you very much.

Mr. REARDON. Can I—

Chairman RISCH. Thank you, Senator Booker, and we will include that article in the record.

Senator BOOKER. Thank you.

[The article follows:]

The New York Times | <https://nyti.ms/2tbymDf>

The Opinion Pages | OP-ED CONTRIBUTOR

Finally, Something Isn't the Matter With Kansas

By MICHAEL TOMASKY JUNE 12, 2017

The most momentous political news of the past week? For my money, it wasn't James Comey's Senate testimony, riveting as it was. It was the Kansas Legislature's decision to defy the governor and raise income taxes — a move that could well be the first step in a transformation of American politics much more far-reaching than anything that could come from Russiagate.

Hear me out. Kansas, under Gov. Sam Brownback, has come as close as we've ever gotten in the United States to conducting a perfect experiment in supply-side economics. The conservative governor, working with a conservative State Legislature, in the home state of the conservative Koch brothers, took office in 2011 vowing sharp cuts in taxes and state spending, except for education — and promising that those policies would unleash boundless growth.

The taxes were cut, and by a lot. The cumulative cut was forecast to be \$3.9 billion by 2019. A fellow at a right-leaning Missouri think tank said in 2015 that Mr. Brownback's cuts were "the biggest tax cut of any state, relative to the size of its economy, in recent history."

The cuts came. But the growth never did. As the rest of the country was growing at rates of just above 2 percent, Kansas grew at considerably slower rates, finally hitting just 0.2 percent in 2016. Revenues crashed. Spending was slashed, even on education: In March, the State Supreme Court ruled that state-level school spending was unconstitutionally low. The court is ideologically mixed, but its ruling was unanimous.

The experiment has been a disaster. Mr. Brownback is widely disliked. If he has anything to be grateful for, it's the existence of Gov. Chris Christie, Republican of New Jersey, who recently swiped from him the title of the nation's most unpopular governor, which Mr. Brownback had held for the better part of three years.

Finally, even the Republican Kansas Legislature faced reality. Earlier this year it passed tax increases, which the governor vetoed. Last Tuesday, the legislators overrode the veto.

Not only is it a tax increase — it's even a progressive tax increase! A married couple filing jointly and earning \$30,000 will pay an additional \$120, which is 0.4 percent of total income, while the same couple earning \$100,000 will fork over \$755, or 0.755 percent. More than half of the Republicans in both houses voted for the increases.

There's the background. Now, why is this a big deal?

Because Republicans are not supposed to raise taxes, ever. In Washington or in the states. This goes back to President George H. W. Bush's agreeing to a bipartisan tax increase in 1990 after famously saying in his 1988 campaign, "Read my lips: no new taxes." Afterward, the conservative group Americans for Tax Reform, led by Grover Norquist, started making Republican candidates for Congress and state houses sign a no-tax pledge.

Ever since, with scattered exceptions, no Republican member of the House or Senate has voted for a tax increase. For 27 years. If you wonder why problems arise and Congress never does anything about them, the tax pledge is usually the answer, or at least *an* answer.

Think we need to build bridges and roads and lay freight rail lines? Of course we do. But we can't. It would require a tax. Think rural Americans need better access to broadband? You bet they do. But doing it right would need a tax. Think we ought to be spending far, far more than we are currently on this hideous opioid crisis, with drug overdoses now being the leading cause of death for Americans under 50? We most surely ought to be. But no — gotta pass those tax cuts.

The Republican no-tax position even bears a share of the blame for our current polarization. Republicans once recognized the principle that public purposes sometimes justified the raising of additional revenue. They might have balked at the specific number the Democrats proposed, but they accepted that taxes were negotiable.

This made compromise possible. The agreement between President Ronald Reagan and Speaker Tip O'Neill in 1983 to save Social Security? It's a famous deal, among insiders, who point to it often as they lament the lost art of the horse trade. It involved benefits cuts — an increase in future retirement ages — and increases in the payroll tax.

Why can't they make those kinds of deals today, you ask, for any number of issues? It's not because there's something in the water. It's not because of cable news, or social media or even the corrupting influence of big money in politics. It's because Republicans won't agree to a penny in tax increases of any kind — income taxes, payroll taxes, the gasoline tax, anything.

So here's hoping that Kansas represents a breakthrough moment. The effects of our failure to invest in ourselves are all around us. Change won't come fast — for one thing, very few Americans know the above, because no one talks about it (hello, Democrats). But at least for now we can say, for the first time in a long time, that something finally isn't the matter with Kansas.

Michael Tomasky is a columnist for The Daily Beast, the editor of *Democracy: A Journal of Ideas* and the author, most recently, of "Bill Clinton."

A version of this op-ed appears in print on June 12, 2017, on Page A21 of the New York edition with the headline: A Tax Revolt in Kansas.

Chairman RISCH. Senator Inhofe.

Senator INHOFE. Thank you, Mr. Chairman. You know, I came from the House to the Senate in 1994, so I have been hanging around here for, what 22, 23 years. And I always remember, because my House district was in primarily just a metropolitan area. It was primarily Tulsa, Oklahoma. And so I got in my little plane and I started going out West, and I remember the first trip was to Shattuck, Oklahoma. I do not think there is anyone in this room who has ever been to Shattuck, Oklahoma, or ever heard of Shattuck, Oklahoma.

But that was when I had my rude awakening of the reality of what really is important. We are a farm State. We are a rural State, Oklahoma, and in Shattuck I can remember a guy, and, John, he had tears in his eyes, and he was talking about how his farm has been in their family for so many generations and all that, but they were going to lose it. They were going to lose it because of the death tax, the inheritance tax.

Since that time—that has been over 20 years—I cannot go into any of our rural areas and have a meeting without that rising as the number one issue. I mean, over and above everything else it always does. It surfaces. And I think we know the arguments there, that, you know, it is an immoral tax, we have already paid money on that, and all that.

So, you know, I would kind of like to get an idea of what you think about that. What would be the effect—the President now has in his budget to eliminate that tax. What would be the results of that, do you think?

Mr. REARDON. I think, particularly for family businesses and large family businesses it would be significant. I think there is an under-appreciation for how much of American economy, how much employment is based in family controlled businesses. We just put out a study, based on the 2704 regs, that Treasury proposed back in August, to highlight the contribution of family controlled businesses. It is significant.

Senator INHOFE. It is.

Mr. REARDON. And the reality is that if the business is large enough, they have to go and buy back a certain portion of that business from the Federal Government every generation that it survives. Public companies do not have to do that. And what that means is that their planning for succession is just a continuous process. You know, some of our they have got, you know, hundreds of family members who are shareholders in these companies and they are just continuously planning for succession, succession, succession. And what that means is that they are draining off revenue from the company, not to go buy boats or do something like that. They are certainly not hiring or building the business. They are doing it just to pay the tax that they know is going to come due the next generation.

Senator INHOFE. Any other thoughts on that? That is really a significant thing, and anymore, that is the only question I get when I am in rural areas, in terms of tax policy.

Another one I keep hearing, and fortunately I do not mean this offensive to anyone, but I am glad that Obama is gone and the war on fossil fuels is officially over, I hope. So when people are talking

about the various deductions that are out there as maybe a way to pay for some of this stuff, I like to bring up the intangible drilling costs and the expensing of that.

You know, I have heard, and I have heard their arguments, and you folks probably have some thoughts on this too, that it really is not going to have any positive effect in accomplishing—if you are doing it for the purpose of offsetting some of the other deductions by doing away with that, until you are against a rate of 20 percent or less, and, of course, the chances of that happening are very remote.

Any thoughts on that particular thing? That is the number one concern, the deduction of the intangible drilling costs for the oil and gas industry.

Mr. REARDON. Sure. I appreciate that that is a priority for the industry. I cannot speak directly to that. I can say that, you know, sort of one of the positive aspects of this discussion right now is that we seem to be moving towards faster cost recovery, not slower cost recovery, which would, you know, suggest that they would preserve that maybe and enhance it.

One of my complaints with the Kemp draft that came out several years ago, we worked with them extensively, was that, you know, after all the work that they put into it, at the end of the day the cost of capital under their plan was higher. That is, the cost of investing in the United States was higher than it was under the existing code. So they did all that work to reform the tax code and they made it more expensive to invest in the United States.

In my mind, that is the bottom line measure. I mean, either we make it so that companies and investors want to invest here and want to create jobs here, or we have failed, and, you know, eliminating or making it more difficult to recover your costs is not going to move in the correct direction.

Senator INHOFE. That is a good argument. Ms. Nellen, you were talking a little bit about the complicated system that we have, and I have always thought of that as being discriminatory against small businesses. They cannot afford to have the resources to handle the complicated system, and, consequently, they do not do a lot of the expanding and normal things that they would be doing.

Has anyone ever put together a study to determine just what we are losing by—with this overly complicated system that is, in my opinion, discriminatory against small business?

Ms. NELLEN. There probably have been studies and certainly, you know, the data that was mentioned here, about the number of hours spent on complying, you know, the National Taxpayer Advocate talks about that if they put that into an industry it would be like the sixth largest industry in the country, so far as the compliance. So that is one way to quantify what is lost on that.

I think, also, the time they are spending. AICPA has been a long-time advocate of simplification, and sometimes people might wonder, well, is not that against your interests?

Senator INHOFE. Yeah, because you guys that are CPAs, you know, you make it simpler and they do not need you as much.

Ms. NELLEN. Well, but I think you would—we would use our resources to help them grow their business. So I think it is looking at what they are losing in compliance as well as what they are los-

ing by not being able to spend that money on someone that can help them to grow and make their business more effective.

Senator INHOFE. Thank you.

Chairman RISCH. Thank you very much, Senator Inhofe. I doubt the CPAs are worried that we are going to put them out of business.

Senator INHOFE. No, and I will tell you what surprises me. I know a lot of CPAs. I have not met one CPA that does not want it simplified. I always kid them, and I say, "Oh, you do not really want that. You know, why do we need you?"

Ms. NELLEN. Well, it is also risk of complexity too, risk of getting the wrong answer for a client, and all that.

Senator INHOFE. Yeah. Good point.

Chairman RISCH. Senator Heitkamp.

Senator HEITKAMP. Thank you, Chairman Risch and Ranking Member Shaheen for holding the hearing. North Dakota is a small business State. Small firms account for 96 percent of businesses and they employ over 200,000 workers, spanning a variety of industries, including farming, manufacturing, and health care services.

When we talk about tax reform, I believe we should start and end the conversation on how it is going to affect small businesses in America. That makes sure we are simplifying compliance, and including the right mix of tax incentives for entrepreneurs to take risk and innovate and grow. I think most importantly, we should be doing tax reform in a bipartisan way so that we have a lasting structural change to the code that can provide small firms with the certainty they need to grow their business.

I do not think there is any doubt about it. I think, just kind of for the record, I used to be on the other side of this. I was actually North Dakota State Tax Commissioner for six years, and before that I was a tax attorney, and I just want to point out one thing, Mr. Reardon. Interestingly enough about the President's budget, where he professed to eliminate the estate tax, he kept the revenue from it. I do not know how that works, but it certainly would make you scratch your head, would it not?

Mr. REARDON. Yes, on many things.

Senator HEITKAMP. The other thing I want to just point out—the other thing I do want to point out is the basis adjustment that would go with elimination of the estate tax, and the need to actually have an honest conversation with small businesses. A farmer in my State may actually find the basis adjustment to be more onerous by having to take it at a basis which their grandfather held that property, might be more onerous to them, looking forward, than actually an estate tax liability. And so we need to be really careful about how we approach the estate tax. But that is neither here nor there.

I am interested in the definition of what is a small business for tax reform purposes. Can anyone want to take that challenge?

Mr. MAZUR. So there is no obvious definition that is in the tax code where you can look and say here is a small business. But if you just look at the distribution of businesses across the spectrum, you would probably land somewhere around \$10 million gross receipts, maybe a little more, but not a lot more than that. And that

really would be sort of the smaller, not quite mom-and-pop, but bigger than mom-and-pop business, but not a giant business, by any stretch of the imagination.

Senator HEITKAMP. There are varying definitions, whether based on the number of shareholders, number of—dollar amount of assets. One thing I also want to point out, as far as what the dollar amount is, it is—I would say it is actually probably more than \$10 million. But something also to bear in mind, some places in the law, where we actually, years ago, defined a small business, those dollar amounts are not adjusted for inflation.

For example, under Code Section 448, that \$5 million threshold for when a C corp can—has to move on to an accrual method, that is about \$11 million today if it was inflation-adjusted. So I think we also have to factor in any dollar amount we come up with, it should be inflation-adjusted so it can remain relevant for—continue to help small business.

Mr. Reardon.

Mr. REARDON. Yeah. I think any effort to sort of draw a bright line is going to be necessarily artificial. So, for instance, you know, Mark's \$10 million threshold, you know, what is the difference between a company that makes \$9 million and a company that makes \$11 million? Do they behave differently? Are they managed or governed differently? Not really.

Plus, if you do a revenue threshold—

Senator HEITKAMP. Well, Koch Petroleum, maybe under your definition, would be a family held business. Are they a small business?

Mr. REARDON. No. They are not a small business, but they are family held, and that gets to my point, which is, I think the one bright line that is out there is the distinction between public companies and private companies, because public companies do, in fact, behave differently than private companies do. They have different regulatory obligations. They have access to markets that private companies do.

So in my mind, you know, I think there is a reason why, for instance, NFIB, the big small business group in town, is called the National Federation of Independent Business, not the National Federation of Small Business. It is because private companies are distinct from public companies, and I would draw the line there.

Senator HEITKAMP. Yeah. I just think that we need to be really careful. I mean, I want—I think we all can recognize that at a certain level, incentivizing behavior, incentivizing investment is a goal of all of ours in helping small businesses grow, helping especially family owned small businesses grow. But at some point we cross the line, whether it is Cargill, whether, you know, Hess. I mean, I can give you any number, especially in the oil and gas industry, which I am well familiar with, where you would not consider them small business but they are independent businesses.

I want to just associate myself with Senator Shaheen's comments about compliance costs. I think it is something that maybe Jean and I sometimes feel lonely in our caucus, talking about this, because I think if you have never done this the way I have, you have no understanding or appreciation for the complexities. And I would maintain today that without tax preparation software, it would be

really hard for a small business or for even a sole proprietor, filing a Schedule C, to actually file their own tax returns.

How do we solve that problem without—just for a minute, you know, when you look at the social engineering and the cost of providing tax benefits, which incentivize behaviors, which is another way of expenditure of Federal money, right? We would all agree tax expenditures are included in the challenges that we have, and there has been a recent report saying tax expenditures are not exceeding regular expenditures on domestic policy.

And so, you know, we understand that there is a whole lot of public policy that is embedded. How do we unravel that history to get to a rate and a formula that is simple and that is fair?

Yeah, Mark.

Mr. MAZUR. I think the example of the 1986 Tax Reform Act was one that is instructive there, that, at that time, in a bipartisan way, Congress and the Administration made a huge effort to get as many of the special provisions out of the tax code as they could, in an effort to lower rates. But you need to do something like that. It is almost a Herculean effort but it takes a lot of people working together to make those tradeoffs.

Senator HEITKAMP. Annette, have you seen any proposal out there that you say, "There is something everybody can get behind?"

Ms. NELLEN. As far as a tax reform, I think probably bits and pieces, but, again, it is probably a work in process.

One comment I want to make is also we should not forget how technology might help on some of the compliance. You had mentioned before about the multistate compliance. You know, technology would help sometimes, perhaps, the tax agency needs that upgrade in the technology as well, to help the practitioner be able to use the technology that is out there. That could streamline a lot of the compliance and the cost.

Senator HEITKAMP. Brian.

Mr. REARDON. So your comment about, you know, technology is right on point. I think without, you know, sort of TurboTax and the other software out there we would have a taxpayer revolt. I know I could not do my taxes without it.

I do not have any specific, kind of other than, you know, sort of one of the reasons why, you know, we have been pushing for sort of rate parity in terms of the top rate, and not just for businesses but for individuals, and also if you eliminate the double tax on corporations you could have dividends and cap gains all at the same rate. If every type of income paid the same top rate, you could eliminate dozens and dozens and dozens of sections of the tax code, and you would make the tax compliance, the tax forms so much shorter, for people with that type of income, because it would not matter anymore if, you know.

Right now, you know, one of the things we struggle with is this idea that, you know, people who own S corps and work there can have their income look like profits as opposed to wages, and they save some—you know, they save their HI taxes. Right? And it is a huge problem, and it is something we struggled with.

Well, if you did not have that differential, you would not have that issue, and you would not have to do the enforcement and all the other stuff. You would not have to have all the C corp, you

know, personal holding company rules. You could eliminate all that stuff. But it would just be by, let us decide what the rate is—I do not care, 28, 30, whatever the rate is—and let us apply that to all the income, and we could eliminate—I guarantee you you could eliminate half of the tax code.

Senator HEITKAMP. Mr. Chairman, just with your indulgence, I once asked a farmer if he would agree to a 2 percent rate per gross receipts—not profitability but just gross receipts, 2 percent. He said, “Sounds like a good idea.” I said, “Tell that to Wal-Mart.” Right? Because obviously Wal-Mart operates on a very small margin. And so the complexity of American business makes this so much harder, and I think it is going to take good-thinking people, at this table and hopefully at podiums like this, to come up with that dialog and to do the back-and-forth. And the frustration that I have is that I do not—I mean, I see a lot of pie in the sky and not a lot of hard work.

So thank you, Mr. Chairman, for indulging me the extra minutes.

Chairman RISCH. Yes. That is no problem, but let me say this. In our caucus, that is a lonely position when you are arguing for compliance costs, and we have more room, just in case—

[Laughter.]

Thank you so much, Senator Heitkamp. Good remarks.

Senator Shaheen, I know you have to be excused to go to another meeting. Did you have any remarks you wanted to make?

Senator SHAHEEN. No. Just thank you all very much and I think it has been a good discussion, and hopefully—the challenge I think we have is making sure, as there are serious discussions about tax reform, that small businesses are at the table, and that is what this committee is here to try and make sure, and why we appreciate your voices, so that we can carry with us the changes that need to happen to support small business.

Thank you.

Chairman RISCH. One of the purposes—before you leave, Senator Shaheen, one of the purposes of this meeting is the fact that people are actually starting to talk about tax reform at this point. Even though we do not have the first problem behind us, they are moving to another one. And, you know, the big businesses, there is an army of lawyers in this town that are going to represent them at the table, and it is going to be up to us, on this committee.

So we are looking for practical suggestions, and we are also looking to prioritize the kinds of things that we need to insist are going to be in any tax reform that will help small businesses, because the voice for small business is probably going to come out of this committee more so than anywhere else, and I can assure you this is not a partisan issue. This is a bipartisan issue, and Senator Shaheen and I will be working on that together. So Senator Shaheen, thank you.

Senator Duckworth, welcome.

Senator DUCKWORTH. Thank you. Thank you, Mr. Chairman. I too am worried about tax reforms for small businesses, to make sure that they also get a part of any type of an effort.

Mr. Mazur, as you noted in your testimony, more and more businesses are choosing to structure themselves as S corps. There are

many benefits that come with this choice. Liability protection and avoiding double taxation. These benefits allow small businesses to use capital to hire workers, buy new equipment, invest in long-term growth.

But, unfortunately, pass-through entities are not limited to just these Main Street companies, small businesses. Certain large businesses that employ hundreds of workers earning millions of dollars of profits each year can also be structured in this way.

According to a Washington Post article from August 10 of last year, 2016, the Trump organization is made up of over 200 pass-through entities, all of which enjoy the same Federal tax benefits as the mom-and-pop small business owners that I represent.

My question is, how can we make sure that small- and medium-sized businesses are receiving the benefits of the S corp and pass-through structures provided while making sure that large entities such as the Trump organization are paying their fair share?

Mr. MAZUR. That is a difficult area, and you have to—it involves a number of tradeoffs. Basically, you want to treat similarly situated businesses in a similar manner. Typically, what we do is we do not look at the size of the organization but we look at the income of the organization to determine what the tax liability should be. Under current law, we have partnerships, LLCs, and S corporations that are pass-throughs, and they get taxed at the individual level.

What has happened over the last three decades is it has become easier for larger businesses to set themselves up as a pass-through organization, either through legislation that Congress has passed, or through State organizational laws, or even just through technology, where investors are much more comfortable dealing with a 1,000-person partnership than they were 30 years ago. So you can have larger businesses in there.

I think that is one of the things that Congress should address, that we just make sure—we should make sure that we are aware small business does not equal pass-through business, as you say, and make a conscious choice of what policies we think are helpful. For smaller business, it seems to me things like simplification, in terms of additional access to cash accounting, or checkbook accounting is a plus for small businesses. Greater expensing limits for capital equipment helps them avoid dealing with depreciation and maintaining basis of these assets. Those are things that can help small businesses actually grow and take away some of their complexity. It is probably a step in the right direction.

Senator DUCKWORTH. Thank you. Ms. Nellen, Chicago is one of the largest and most densely populated cities in the United States. I represented, when I was in the House, one of the largest concentrations of tool-and-die manufacturers in the Nation, was in my little congressional district. We had many, manufacturing businesses who have skilled job openings to this day. In fact, the American Manufacturing Association has said that the largest, greatest impediment to them gaining in market share is actually access to a skilled workforce.

At the same time, Chicago and Cook County saw the largest population loss than any other county in 2016, with unemployment being one of the reasons cited as to why people were leaving. This

is a dichotomy, particularly troubling as Illinois has one of the highest unemployment rates among black and brown communities, in particular.

And so from your extensive experience working with tax policy, are there specific tax provisions on the books that you would add to incentivize STEM education, technical training, hiring of veterans, economically disadvantaged, and those who have committed a criminal offense, to allow them to re-enter society? Let's take advantage of that workforce that is not getting the training that they need. Are there any tax incentives you can come up with that would help with that educational process?

Ms. NELLEN. Yes. In the line with education provisions and the AICPA has commented on mainly the complexity of all of those, but, so, yeah, as part of tax reform that would be one big area, certainly, to look at, because it is a lot of complexity. It is benefiting, actually, for higher education, why just higher education so far as college education. If you are talking about a skilled workforce that perhaps does not need a college education but needs advanced education, perhaps if the education credits stay they should be more broadly focused on preparing people for jobs out there, as opposed to only subsidizing higher education.

But the whole realm of education provisions does need to be simplified, and yes, it would absolutely be a benefit to small business if they had a better assurance of seeing a skilled workforce available that they can hire in a local area.

Senator DUCKWORTH. What do the manufacturers do if the average starting salary of someone on their assembly line, because they are such highly technical manufacturing businesses is \$60,000, which is a pretty good salary to making for someone without a four-year university education. I have run out of time. I yield back, Mr. Chairman. Thank you.

Chairman RISCH. Thank you very much, Senator.

Well, thank you to our witnesses for being here. As I said, our charge here, I believe, is to represent small businesses as we wade into this, when small businesses will not have the voice that some of the larger businesses do. We are committed to do that. We want to hear ideas about it. For that reason, we are going to keep the record open for another couple of weeks for you, or anyone else, really, to provide us with their thoughts on how we ought to do this as we wade into tax reform.

So with that, thank you again, everyone who participated, and with that the hearing will be adjourned.

Ms. NELLEN. Thank you.

[Whereupon, at 4:12 p.m., the Committee was adjourned.]

APPENDIX MATERIAL SUBMITTED



August 9, 2017

The Honorable James Risch
Chairman
Committee on Small Business & Entrepreneurship
United States Senate
428A Russell Senate Office Building
Washington, DC 20510

RE: Answers to Follow-Up Questions for the Record, June 14, 2017 Hearing on "Tax Reform:
Removing Barriers to Small Business Growth"

Dear Chairman Risch:

As requested in your letter dated July 26, 2017, attached are the American Institute of CPAs (AICPA) answers to the five questions posed by you.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state, local and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

If you have any questions, please feel free to contact me at (408) 924-3508, or annette.nellen@sjsu.edu; or Melissa Labant, AICPA Director of Tax Policy & Advocacy, at (202) 434-9234, or melissa.labant@aicpa-cima.com.

Sincerely,

A handwritten signature in black ink, appearing to read 'Annette Nellen'.

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

AICPA Answers to Follow-Up Questions for the Record
 U.S. Senate Committee on Small Business & Entrepreneurship
 June 14, 2017 Hearing on "Tax Reform: Removing Barriers to Small Business Growth"
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Answers to Follow-Up Questions

Cash Method Accounting for Small Businesses

Businesses making less than \$5 million may use cash accounting rather than the more complicated accrual method. The cash method more accurately reflects small business expenses and reduces record-keeping and paperwork costs. Raising the threshold for businesses who can use cash accounting would help many small businesses.

QUESTION 1:

The AICPA supports the expansion of the number of taxpayers who can use cash method accounting, which is often used by small businesses. What kind of expansion of the use of cash method accounting does AICPA support or suggest is reasonable? Would AICPA support an increase in the threshold for businesses who can use this method of accounting above the current \$5 million?

ANSWER 1:

The AICPA strongly believes that sole proprietors, pass-through entities and qualified personal service corporations should not have any dollar cap or threshold on the use of the cash method. For those businesses subject to a threshold, AICPA believes that adjusting any dollar cap annually for inflation is important. In addition to greater simplicity, the cash method involves fewer compliance costs and prevents businesses from having to pay tax on income prior to receiving it.

The AICPA believes it is important that tax reform not restrict use of the cash method. We believe that forcing more businesses to use the accrual method of accounting for tax purposes increases their administrative burden, discourages business growth in the United States economy, and unnecessarily imposes financial hardship on cash-strapped businesses. As noted in our testimony, we support expansion of the number of taxpayers who may use the cash method of accounting.

Compliance Issues for Small Businesses

Tax compliance costs are 67 percent higher for small businesses than for big businesses. Complying with tax laws and regulations costs small business owners \$18 to \$19 billion per year. Paperwork costs come to \$74.24 per hour.

QUESTION 2:

You've outlined a number of small business compliance issues, including rules for retirement plans, listed property, and executive compensation to name a few. Can you describe what you believe are the top three compliance issues for small businesses that, if addressed, would most help small business growth moving forward?

ANSWER 2:

The top three compliance issues for small businesses are:

1. Alternative minimum tax (AMT) compliance (the AICPA supports repeal of the AMT).
2. Figuring out and complying with the myriad of state tax rules regarding withholding for mobile employees (the AICPA supports S. 540, Mobile Workforce State Income Tax Simplification Act of 2017).

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3. Dealing with temporary provisions (the AICPA finds that uncertainty of the tax law creates unnecessary confusion and increased compliance costs).

Difficulty Dealing with the Internal Revenue Service (IRS)

Few small businesses have accounting or human resources specialists to handle taxes, so administrative tasks fall to owners, diverting them from their core businesses. Because they lack tax expertise (and do not have in-house tax expertise), 89 percent of small business owners rely on outside tax preparers. Compliance issues also include anecdotal evidence from small businesses about their difficulty working with the IRS.

QUESTION 3:

In your testimony, you discuss some of the compliance issues small businesses face with the current tax code. With all of these issues, and knowing that the great majority of small businesses rely on outside tax preparers to help them with their tax issues, can you speak to difficulties CPAs and small businesses have dealing with the IRS? How could the IRS help make compliance easier for small businesses?

ANSWER 3:

Small businesses and their CPAs face challenges in effectively interacting with the IRS. The percentage of calls from taxpayers that the IRS answered between 2004 and 2016 dropped from 87 percent to 53 percent. Comparing 2004 to 2016, the number of calls the IRS received from taxpayers increased from 71 million to 104 million, yet the number of calls answered by telephone assistants declined from 36 million to 26 million.¹

Our recommendations include modernizing IRS business practices and technology, re-establishing the annual joint hearing review, and enabling the IRS to utilize the full range of available authorities to hire and compensate qualified and experienced professionals from the private sector to meet its mission.²

Additionally, we recommend that Congress direct the IRS to create a new dedicated practitioner services unit to rationalize, enhance, and centrally manage the many current, disparate practitioner-impacting programs, processes, and tools. Enhancing the relationship between the IRS and practitioners would benefit both the IRS and the millions of taxpayers, including numerous small businesses, served by the practitioner community. As part of this new unit, the IRS should provide practitioners with an online tax professional account with access to all of their clients’ information. The IRS should offer robust practitioner priority hotlines with higher-skilled employees who have the experience and training to address complex issues. Furthermore, the IRS should assign customer service representatives (a single point of contact) to geographic areas in order to address challenging issues that practitioners could not resolve through a priority hotline.

¹ See National Taxpayer Advocate, “*Annual Report to Congress 2016, Executive Summary: Preface, Special Focus and Highlights*,” page 6, 2016.

² For additional details see AICPA letter, “*Ensuring a Modern-Functioning IRS for the 21st Century*,” April 3, 2017.

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Need for Small Business Review Panels

Small Business Review panels ("SBREFA" Panels) are currently only in place to review the regulatory flexibility analyses that the Environmental Protection Agency, Occupational Safety and Health Association, and Consumer Financial Protection Bureau perform for their proposed rules. Two entities that the Office of Advocacy has cited as frequently failing to perform their regulatory flexibility analyses are the Fish and Wildlife Service (FWS) and the IRS. You have legislation to expand the use of the SBREFA panels to FWS and IRS, to help ensure that they fully consider the effects of their rules on small entities.

QUESTION 4:

The rulemakings at the IRS have significant effects on small businesses, creating large compliance burdens. Since the IRS frequently fails to perform regulatory flexibility analyses for their proposed rules, do you think that small business review panels for major rules would give small businesses a voice in the financial regulatory process?

ANSWER 4:

The AICPA has not studied or worked with these types of panels. We do not have a position on Question 4.

Eliminating the AMT

The AMT requires taxpayers to calculate their taxes a second time over, using a complicated set of rules and definitions. Even though only 3.9 million taxpayers end up owing the AMT, over 9.7 million taxpayers are required to go through the arduous steps of calculating their possible AMT liability each year.

QUESTION 5:

In your testimony, you detail the heavy burden AMT places on small businesses and recommend repeal of the AMT. Can you estimate how many small businesses are faced with this challenge and how many small businesses pay AMT each year? How significant a burden is the AMT for small business owners?

ANSWER 5:

The AICPA believes that the AMT is a significant burden for small businesses and their owners.

While small C corporations have an exemption from AMT (section 55(e)), most small businesses operate outside of the C corporation form. Any sole proprietor with income near or above the AMT exemption amount for individuals is burdened with AMT rules and recordkeeping even if it is not owed. Partnerships and S corporations are similarly burdened with AMT reporting and recordkeeping as these entities do not always know if their owners are subject to AMT.

**Senate Committee on Small Business and Entrepreneurship Hearing
June 14, 2017
Follow-Up Questions for the Record**

Questions for Mr. Brian Reardon

Questions from:

Chairman Risch

On the Need for Reforming the Individual Code

Today, 95 percent of businesses are considered to be sole proprietorships or pass through entities. More than 50 percent of business income in the U.S. comes from small businesses designated as sole proprietorships or pass through entities.

QUESTION 1:

We're here today to discuss the issues small businesses face with the current tax code and the need to consider reforming the individual code in any tax reform discussion. Can you discuss the consequences that would result if we only reform the corporate code and do not consider the individual code, through which most small businesses are taxed?

The idea of corporate-only tax reform was first floated by the Obama Administration in 2011 and it immediately raised alarms. A reform that broadens the tax base for all businesses but only reduces corporate tax rates would result in higher taxes on pass through businesses and put them at a competitive disadvantage.

To find out what this would mean to the Main Street business sector and the economy, we asked Ernst & Young to measure the economic footprint of the pass through community and the implications of corporate only reform. Their findings:

- Fifty-four percent of all private sector workers (69 million) work for flow-through businesses.
- One out of four private sector workers (31 million) is employed by an S corporation.
- Nearly one in six private sector workers (20 million) works for a flow-through business with more than 100 employees.
- States with the highest rate of flow-through employment – with more than 60 percent of the private workforce – include Idaho, Maine, Montana, South Dakota, Vermont and Wyoming.

These same employers would be asked to pay sharply higher rates on a significantly broader base of income under corporate-only tax reform. According to the study:

- Pass-through businesses will see their tax burden rise by eight percent (\$27 billion) per year under budget neutral, corporate-only tax reform.

- Their tax base would increase through the elimination of numerous businesses deductions and credits, including accelerated depreciation, the domestic production activities deduction, and changes to inventory accounting rules.

The bottom line is that the majority of workers are employed by America's pass through businesses, so any reform of the tax code needs to treat them as equal partners and reduce their rates right alongside rate cuts for C corporations.

QUESTION 2:

Idaho is one of the states with the highest level of pass through employment, and I have a great interest in making it easier for Idahoans to grow their businesses and spend less time complying with the tax code. Further, I'd like to see a simpler system with lower rates. Can you expand on what you've heard from your membership are their top issues with the tax code and what a simpler individual code with certainty would do for pass throughs across the country?

Simplification is often described as reducing the number of tax rates, but what about tax codes? If you define a tax code as a distinct set of rates applied to a distinct definition of income, then we have at least five tax codes at the federal level:

- Income Taxes
- Payroll Taxes
- ACA Investment Surtax
- Estate Taxes
- Alternative Minimum Taxes

Five! That's simply too many. And unlike brackets, taxing the same income multiple times really does contribute to complexity. The more layers of tax, the more taxpayers adjust their behavior to avoid them. And like drug interactions, there is no way to be certain that the net result of all those tax codes is to hurt the very thing you are trying to help.

For example, the regular tax code offers businesses a tax credit for research expenses; the goal is to incent research and development here in the United States. But the R&E tax credit is not available under the Alternative Minimum Tax, so business owners who plan out their research and incur the investment costs often learn, after the fact, they don't qualify for the credit for no other reason than they are paying taxes under the wrong tax code.

The estate tax is another needless complication. Advocates of the estate tax argue that it helps raise revenue while reducing income inequality. It does neither to any significant degree, but as a tax on capital, it hurts investment and job creation while making life more difficult for families when their father or mother dies.

The challenge of the estate tax is easy to identify – nobody knows when they are going to die and very few people know exactly how much their estate is worth, so we have created a tax where the taxpayer doesn't know when the tax will be due or how much it will be. That uncertainty results in excessive and often wasted tax planning costs.

A simple solution would be to trade the estate tax for a capital gains tax applied when the assets are sold. Such an approach would be more humane and it would eliminate the uncertainty and planning expenses of the estate tax.

So real simplification would eliminate the AMT, the investment surtax, and the estate tax and reduce the number of tax codes to one or two, not five.

Reducing the layers of tax should be another priority. Income should be taxed once when it is earned, not two or three times. The most prominent example of multi-layered taxes is how we tax corporate income. Corporate income is first taxed at the business level, and then again when it is distributed to the corporation's shareholders.

Tax and economic literature (and political discourse too) is rife with examples of how this double corporate tax reduces hiring and investment by altering taxpayer behavior. Corporate executives make specific investment and hiring decisions in order to avoid the double tax. Shareholders forgo or delay selling shares for the same reason. People behave differently to avoid tax liability and, as a result, the economy suffers.

Any real tax reform would eliminate the double tax on corporate profits and tax all business income only once when it is earned, and at reasonable rates.

Another contributor to complexity is the practice of taxing different forms of income at different rates. Prior to the Reagan tax relief in 1981, individual income was taxed at a top rate of 70 percent, while corporate income was taxed at a much lower rate. Over time, wealthy taxpayers made sure to shift the bulk of their income into the corporate structure to access the lower rate. They would also push as many costs as possible into the corporation.

Back then, the IRS spent much of its time auditing and disallowing "business" expenses including cars, boats, vacations and homes. Congress enacted numerous administrative reforms to crack down on gaming.

The tax reform of 1986 largely equalized the top rates paid on wage, investment, and business income, the gaming stopped, and taxpayers focused their attention on making business decisions, not tax decisions.

Real reform would restore rate parity, so that the top rates on all forms of income would set at similar, reasonable rates.

QUESTION 3:

Small businesses create the majority of new jobs in the country and account for over half of all U.S. sales. This is true with the current tax structure that is complicated, burdensome and difficult to comply with. What do you think would happen in the small business sector if tax reform were to be accomplished with lower rates and a simplified code? What kind of growth do you think we'd see?

The growth potential of the economy is limited in the long term to the growth in hours worked plus increases in productivity – in other words, increases in labor and capital. But that's the long term, and that is the potential. The simple reality is that the United States' economy has been growing below potential for a long time, and there's a lot of room to play catch up. Labor participation is down sharply from its highs, while productivity growth is at historic lows for this stage of the recovery. As the BLS reported:

These historical comparisons make it clear that the shock to output growth which took place during the Great Recession has not been resolved. The fact that output growth has not risen above 3.2 percent in any single year since the recession underlines the fact that the higher-than-average growth rates which would be necessary for the U.S. economy to climb back to pre-recessionary trends have not been present during this recovery. At this point in the recovery, it would require a dramatic increase in output growth rates to resolve this situation.

In simple terms, this gap between actual and potential economic output means a robust tax reform unleashing the full potential of American businesses large and small and could result in years of economic growth of three percent, four percent, or more. Growth at this level would help to restore wage growth for American workers while encouraging more Americans to return to the workforce.

Question for: Mr. Mark J. Mazur¹

Question from: Chairman Risch

On Section 179 Expensing for Small Businesses

Section 179 expensing allows a small business to immediately deduct the cost of investing in their business—up to \$500,000 of qualifying property and equipment each year. This deduction puts money back into the small business for investment rather than spreading the deductions out over a long depreciation schedule. Expensing also reduces tax complexity by eliminating the paperwork and record-keeping burden associated with longer depreciation periods.

QUESTION 1

In your testimony, you discussed Section 179 expensing and how small businesses use this deduction. You also mention a reexamination of this provision may be warranted to increase simplification and spur innovation: can you expand on this statement and discuss any concrete suggestions you have for this provision were it reevaluated?

RESPONSE

Section 179 expensing is an important incentive for capital investment made by smaller firms. It is also a source of simplification, because firms taking advantage of it do not need to keep track of accumulated depreciation and maintain records indicating the adjusted basis of their productive physical assets. Increasing the current law \$500,000 limitation to \$1 million (and indexing the amount for future inflation) would help ensure that smaller businesses can make significant capital investments in a tax-advantaged way and would expand the simplification benefits provided by Section 179 to these firms. In addition to increasing the limitation, increasing the dollar threshold on investment where the benefit begins to phase out from the current law \$2 million (indexed for inflation, so the value is \$2,030,000 in 2017) to a larger figure (such as \$3 million, also indexed for inflation) would ensure that more smaller firms can benefit.

¹ The views expressed are those of Mr. Mazur and should not be attributed to the Tax Policy Center, the Urban Institute, the Brookings Institution, their boards, or their funders.



**Statement of the
American Farm Bureau Federation**

**SUBMITTED FOR THE HEARING RECORD
UNITED STATES SENATE COMMITTEE
ON SMALL BUSINESS AND ENTREPRENEURSHIP**

**"TAX REFORM: REMOVING BARRIERS TO SMALL BUSINESS
GROWTH"**

JUNE 14, 2017

**Submitted By:
The American Farm Bureau Federation**

The American Farm Bureau Federation is the country's largest general farm organization, with nearly 6 million member families and representing nearly every type of crop and livestock production across all 50 states and Puerto Rico. Our members grow and produce the food, fiber and fuel that propel our nation's economy as well as putting food on our tables. According to USDA, 11 percent of U.S. employment comes from the agriculture and food industry, accounting for 21 million jobs of which about 18 million are off-the-farm positions.

Federal tax policy affects the economic behavior and well-being of farm households as well as the management and profitability of farm and ranch businesses. Farm Bureau supports replacing the current federal income tax with a fair and equitable tax system that encourages success, savings, investment and entrepreneurship. We appreciate the opportunity to file this statement explaining the importance of tax reform and highlighting tax code provisions important to the long-term financial success of farm and ranch businesses.

Farms and ranches operate in a world of uncertainty. From unpredictable commodity and product markets to fluctuating input prices, from uncertain weather to insect or disease outbreaks, running a farm or ranch business is challenging under the best of circumstances. Farmers and ranchers need a tax code that recognizes the financial challenges that impact agricultural producers. They want a simpler more transparent tax code that doesn't make the challenging task of running a farm or ranch business more difficult than it already is.

Farm Bureau supports tax laws that help the family farms and ranches that grow America's food and fiber, often for rates of return that are modest compared to other business opportunities. What is needed is tax reform that supports high-risk, high-input, capital-intensive businesses like farms and ranches that predominantly operate as sole proprietors and pass-through entities. We believe that tax reform should be equitable and designed to encourage private initiative and domestic economic growth.

Farm Bureau commends the Committee on Small Business & Entrepreneurship for holding this hearing on ways to encourage small business growth. Many tax code changes under discussion will be beneficial to farmers, including reduced income tax rates, reduced capital gains taxes, immediate expensing for all business inputs except land, and the elimination of the estate tax. Proposals to end the loss of the deduction for business interest expense and the deduction for state and local taxes, however, are a cause for concern. Also important to farming and ranching is the continuation of stepped-up basis, preserving cash accounting and maintaining like-kind exchanges.

The statement that follows focuses on and provides additional commentary on the tax reform issues most important to farmers and ranchers.

COMPREHENSIVE TAX REFORM WILL BOOST FARM AND RANCH BUSINESSES

Any tax reform proposal considered by Congress must be comprehensive and include individual as well as corporate reform and rate reduction. By far, the most common form of farm ownership is as a sole-proprietor. In total, farms and ranches operated as individuals, partners and S corporation shareholders constitute about 97 percent of our nation's 2 million farms and ranches

and about 85 percent of total agricultural production. Because many business deductions and credits are used by both corporate and pass-through businesses, their elimination without substantial rate reduction for all business entities could result in a tax increase for the vast majority of farmers and ranchers.

LOWER EFFECTIVE TAX RATES WILL BENEFIT FARM AND RANCH BUSINESSES

Farm Bureau supports reducing tax rates and views this as the most important goal of tax reform. While lower tax rates are important, the critical feature for farmers and ranchers is the effective tax rate paid by farm and ranch businesses. Tax reform that lowers rates by expanding the base should not increase the overall tax burden (combined income and self-employment taxes) of farm and ranch businesses. Because profit margins in farming and ranching are tight, farm and ranch businesses are more likely to fall into lower tax brackets. Tax reform plans that fail to factor in the impact of lost deductions for all business entities and for all rate brackets could result in a tax increase for agriculture.

Farming and ranching is a cyclical business. A period of prosperity can be followed by one or more years of low prices, poor yields or even a weather disaster. Without the opportunity to even out income over time, farmers and ranchers will pay more than comparable non-cyclical businesses. Tax code provisions like income averaging allow farmers and ranchers to pay taxes at an effective rate equivalent to a business with the same aggregate but steady revenue stream. Farm savings accounts would accomplish the same object plus allow a farmer or rancher to reserve income in a dedicated savings account for withdrawal during a poor financial year. Installment sales of land benefits both buyers and sellers by providing sellers with an even income flow and buyers with the ability to make payments over time.

ACCELERATED COST RECOVERY HELPS FARMERS REMAIN EFFICIENT

Farmers and ranchers need to be able to match income with expenses in order to manage their businesses through challenging financial times. Expensing allows farm and ranch business to recover the cost of business investments in the year a purchase is made. In addition to Sect. 179 small business expensing, the tax code also provides immediate cost recovery through bonus depreciation and through long-standing provisions that allow for the expensing of soil and water conservation expenditures, expensing of the costs of raising dairy and breeding cattle and for the cost of fertilizer and soil conditioners such as lime. Farm Bureau supports the expansion of immediate expensing.

Because production agriculture has high input costs, Farm Bureau places a high value on the immediate write-off of all equipment, production supplies and pre-productive costs. While Sect. 179 does provide full expensing for most small and mid-size farms, USDA reports that almost a quarter of the large farms that account for nearly half of all agricultural production made investments exceeding the expensing limit in 2015. Thus, an expansion of immediate expensing has the potential to change the investment behavior of farms responsible for a significant amount of agriculture production.

When farmers are not allowed immediate expensing they must capitalize purchases and deduct the expense over the life of the property. Accelerated deductions reduce taxes in the purchase year, providing readily available funds for upgrading equipment, to replace livestock, to buy production supplies for the next season and for farmers to expand their businesses. This is a not only a benefit to production agriculture; a journal Agricultural Finance Review study found that for every \$1,000 increase to the Section 179 expensing amount, farms that had been previously limited by the expensing amount made an incremental capital investment of between \$320 and \$1,110.

CASH ACCOUNTING HELPS FARM AND RANCH BUSINESSES TO CASH FLOW

Cash accounting is the preferred method of accounting for farmers and ranchers because it allows them to match income with expenses and aids in tax planning. Farm Bureau supports the continuation of cash accounting.

Cash accounting allows farmers and ranchers to improve cash flow by recognizing income when it is received and recording expenses when they are paid. This provides the flexibility farmers need to plan for major business investments and in many cases provides guaranteed availability of some agricultural inputs.

Under a progressive tax rate system, farmers and ranchers, whose incomes can fluctuate widely from year to year, will pay more total taxes over a period of time than taxpayers with more stable incomes. The flexibility of cash accounting also allows farmers to manage their tax burden on an annual basis by controlling the timing of revenue to balance against expenses and target an optimum level of income for tax purposes.

Loss of cash accounting would create a situation where a farmer or rancher might have to pay taxes on income before receiving payment for sold commodities. Not only would this create cash flow problems, but it also could necessitate a loan to cover ongoing expenses until payment is received. The use of cash accounting helps to mitigate this challenge by allowing farm business owners to make tax payments after they receive payment for their commodities.

DEDUCTING INTEREST EXPENSE IS IMPORTANT FOR FINANCING

Debt service is an ongoing and significant cost of doing business for farmers and ranchers who must rely on borrowed money to buy production inputs, vehicles and equipment, and land and buildings. Interest paid on these loans should be deductible because interest is a legitimate business expense. According to USDA Economic Research Service, the interest expense accounts for 17.9 percent of fixed expenses for farms and ranches. Immediate expensing will not offset the loss of this deduction, especially for the bulk of farmers and ranchers currently covered under Sect. 179 small business expensing.

Farm and ranch businesses are almost completely debt financed with little to no access to investment capital to finance the purchase of land and production supplies. In 2015, all but

5 percent of farm sector debt was held by banks, life insurance companies and government agencies. Without a deduction for interest, it would be harder to borrow money to purchase land and production inputs and the agriculture sector could stagnate.

Land has always been farmers' greatest asset, with real estate accounting for 79 percent of total farm assets in 2015. Since almost all land purchases require debt financing, the loss of the deduction for mortgage interest would make it more difficult to cash flow loan payments and could even make it impossible for some to secure financing at all. The need for debt financing is especially critical for new and beginning farmers who need to borrow funds to start their businesses.

REPEALING ESTATE TAXES WILL AID IN FARM TRANSITIONS

Estate taxes disrupt the transition of farm and ranch businesses from one generation to the next. Farm Bureau supports estate tax repeal, opposes the collection of capital gains taxes at death and supports the continuation of unlimited stepped-up basis.

Farming and ranching is both a way of life and a way of making a living for the millions of individuals, family partnerships and family corporations that own more than 99 percent of our nation's more than 2 million farms and ranches. Many farms and ranches are multi-generation businesses, with some having been in the family since the founding of our nation.

Many farmers and ranchers have benefited greatly from congressional action that increased the estate tax exemption to \$5 million indexed for inflation, provided portability between spouses, and continued the stepped-up basis. Instead of spending money on life insurance and estate planning, farmers are able to upgrade buildings and purchase equipment and livestock. And more importantly, they have been able to continue farming when a family member dies without having to sell land, livestock or equipment to pay the tax.

In spite of this much-appreciated relief, estate taxes are still a pressing problem for some agricultural producers. One reason is that the indexed estate tax exemption, now \$5.49 million, is still catching up with recent increases in farmland values. While increases in cropland values have moderated over the last three years, cropland values remain high. On average cropland values are 62 percent higher than they were a decade ago. As a result, more farms and ranches now top the estate tax exemption. With 91 percent of farm and ranch assets illiquid, producers have few options when it comes to generating cash to pay the estate tax.

REDUCED TAXATION OF CAPITAL GAINS ENCOURAGES INVESTMENT

The impact of capital gains taxes on farming and ranching is significant. Production agriculture requires large investments in land and buildings that are held for long periods of time during which land values can more than triple. USDA survey data suggests about 40 percent of all family farms and ranches report some gain or loss, more than three times the average individual taxpayer. Farm Bureau supports reducing capital gains tax rates and wants an exclusion for farm land that remains in production.

Capital gains taxes are owed when farm or ranch land, buildings, breeding livestock and some timber are sold. While long-term capital gains are taxed at a lower rate than ordinary income to encourage investment and in recognition that long-term investments involve risk, the tax can still discourage property transfers or alternatively lead to a higher asking price.

Land and buildings typically account for 79 percent of farm or ranch assets. The current top capital gains tax is 20 percent. Because the capital gains tax applies to transfers, it provides an incentive to hold rather than sell land. This makes it harder for new farmers and producers who want to expand their business, say to include a child, to acquire property. It also reduces the flexibility farms and ranches need to adjust their business structures to maximize use of their capital.

STEPPED-UP BASIS REDUCES TAXES FOR THE NEXT GENERATION OF PRODUCERS

There is also interplay between estate taxes and capital gains taxes: stepped-up basis. Step-up sets the starting basis (value) of land and buildings at what the property is worth when it is inherited. Farm Bureau supports continuation of stepped-up basis.

Capital gains taxes on inherited assets are owed only when sold and only on gains over the stepped-up value. If capital gains taxes were imposed at death or if stepped-up basis were repealed, a new capital gains tax would be created and the implications of capital gains taxes as described above would be magnified. This is especially true for the vast majority of farmers and ranchers who are both under the estate tax exemption and have the benefit of stepped-up basis.

Stepped-up basis is also important to the financial management of farms and ranches that continue after the death of a family member. Not only are land and buildings eligible for stepped-up basis at death but so is equipment, livestock, stored grains, and stored feed. The new basis assigned to these assets resets depreciation schedules, providing farmers and ranchers with an expanded depreciation deduction.

LIKE-KIND EXCHANGES HELP AG PRODUCERS STAY COMPETITIVE

Like-kind exchanges help farmers and ranchers operate more efficient businesses by allowing them to defer taxes when they sell assets and purchase replacement property of a like-kind. Farm Bureau supports the continuation of Sect. 1031 like-kind exchanges.

Like-kind exchanges have existed since 1921 and are used by farmers and ranchers to exchange land and buildings, equipment, and breeding and production livestock. Without like-kind exchanges some farmers and ranchers would need to incur debt in order to continue their farm or ranch businesses or, worse yet, delay mandatory improvements to maintain the financial viability of their farm or ranch.

FARMERS AND RANCHERS PAY SIGNIFICANT STATE AND LOCAL TAXES

Farm Bureau supports continuation of the deduction for state and local taxes. Loss of the deduction for state and local taxes paid would have a significant impact on farm and ranch

businesses. According to USDA Economic Research Service, state and local property taxes account for 16 percent of fixed expenses for all farms. An additional, important contributing factor is that taxes are often built into the price of rent and lease payments, which are substantial for farms. Therefore, losing the state and local tax deduction would likely cause higher rent and lease payments. It should be noted that the figures for taxes mentioned above are only for real estate and property taxes and do not include any state income taxes if those exist. Therefore, the overall local and state tax burden is likely higher than stated above.

SUMMARY

Farm Bureau supports replacing the current federal income tax with a fair and equitable tax system that encourages success, savings, investment and entrepreneurship. We believe that the new code should be simple, transparent, revenue-neutral and fair to farmers and ranchers. Tax reform should embrace the following overarching principles:

- Comprehensive: Tax reform should help all farm and ranch businesses, including sole-proprietors, partnerships and sub-S and C corporations.
- Effective Tax Rate: Tax reform should reduce combined income and self-employment tax rates low enough to account for any deductions/credits lost due to base broadening.
- Cost Recovery: Tax reform should allow businesses to deduct expenses when incurred, including business interest expense. Cash accounting should continue. Sect. 1031 like-kind exchanges should continue. There should be a deduction for state and local taxes.
- Estate Taxes: Tax reform should repeal estate taxes. Stepped-up basis should continue.
- Capital Gains Taxes: Tax reform should lower taxes on capital investments. Capital gains taxes should not be levied on transfers at death.



June 12, 2017

The Honorable James Risch
Chairman
Committee on Small Business & Entrepreneurship
United States Senate
428A Russell Senate Office Building
Washington, DC 20510

The Honorable Jeanne Shaheen
Ranking Member
Committee on Small Business & Entrepreneurship
United States Senate
428A Russell Senate Office Building
Washington, DC 20510

RE: June 14, 2017 Hearing on "Tax Reform: Removing Barriers to Small Business Growth"

Dear Chairman Risch and Ranking Member Shaheen:

On behalf of the American Institute of CPAs (AICPA), I have been invited to testify at the Senate Committee on Small Business & Entrepreneurship hearing on "Tax Reform: Removing Barriers to Small Business Growth" on June 14, 2017.

The AICPA respectfully submits the enclosed written statement for the record. We appreciate the efforts of the Committee for their commitment to reducing the tax compliance burden on small businesses.

The AICPA is the world's largest member association representing the accounting profession with more than 418,000 members in 143 countries and a history of serving the public interest since 1887. Our members advise clients on federal, state, local and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

If you have any questions, please feel free to contact me at (408) 924-3508, or annette.nellen@sisu.edu; or Melissa Labant, AICPA Director of Tax Policy & Advocacy, at (202) 434-9234, or melissal.labant@aicpa-cima.com.

Sincerely,

Annette Nellen, CPA, CGMA, Esq.
Chair, AICPA Tax Executive Committee

1455 Pennsylvania Ave. NW, Washington, DC 20004-1081
T: +1 202.737.6600 F: +1 202.638.4512
aicpaglobal.com | cimaglobal.com | aicpa.org | cgma.org

June 28, 2017

The Honorable James Risch
Chairman
Senate Committee on Small Business
& Entrepreneurship
428A Russell Senate Office Building
Washington, D.C. 20510

The Honorable Jeanne Shaheen
Ranking Member
Senate Committee on Small Business
& Entrepreneurship
428A Russell Senate Office Building
Washington, D.C. 20510

Dear Chairman Risch and Ranking Member Shaheen:

In connection with the Senate Committee on Small Business & Entrepreneurship's June 14, 2017 hearing on *Tax Reform: Removing Barriers to Small Business Growth*, we are submitting as a statement for the record the attached letter urging you to preserve the ability of farmers, ranchers, and service pass-through businesses to use the cash method of accounting. Thank you for your consideration and your leadership on these important issues.

Sincerely,

The Coalition to Preserve Cash Accounting

June 28, 2017

The Honorable James Risch
Chairman
Senate Committee on Small Business
& Entrepreneurship
428A Russell Senate Office Building
Washington, D.C. 20510

The Honorable Jeanne Shaheen
Ranking Member
Senate Committee on Small Business
& Entrepreneurship
428A Russell Senate Office Building
Washington, D.C. 20510

Dear Chairman Risch and Ranking Member Shaheen:

On behalf of the Coalition to Preserve Cash Accounting (“the Coalition”), we are writing to explain why it is important to continue to allow farmers, ranchers, and service provider pass-through businesses to continue to use the cash method of accounting as part of any tax reform plan. The Coalition applauds your efforts to improve the nation’s tax code to make it simpler, fairer and more efficient in order to strengthen the U.S. economy, make American businesses more competitive, and create jobs. We appreciate the opportunity to provide these comments.

The Coalition is comprised of dozens of individual businesses and trade associations representing thousands of farmers, ranchers, and service provider pass-through entities across the United States that vary in line of business, size and description, but have in common that our members rely on the use of cash accounting to simply and accurately report income and expenses for tax purposes. Pass-through entities account for more than 90 percent of all business entities in the United States. A substantial number of these businesses are service providers, farmers, and ranchers that currently qualify to use cash accounting. They include a variety of businesses throughout America - farms, trucking, construction, engineers, architects, accountants, lawyers, dentists, doctors, and other essential service providers - on which communities rely for jobs, health, infrastructure, and improved quality of life. These are not just a few big businesses and a few well-to-do owners. According to IRS data, there are over 2.5 million partnerships using the cash method of accounting, in addition to hundreds of thousands of Subchapter S corporations eligible to use the cash method.

About the Cash Method of Accounting

Under current law, there are two primary methods of accounting for tax purposes - cash and accrual. Under cash basis accounting, taxes are paid on cash actually collected and bills actually paid. Under accrual basis accounting, taxes are owed when the right to receive payment is fixed, even if that payment will not be received for several months or even several years; expenses are deductible even if they have not yet actually been paid.

The tax code permits farmers, ranchers, and service pass-through entities (with individual owners paying tax at the individual level) of all sizes - including partnerships, Subchapter S corporations, and personal service corporations - to use the cash method of accounting. Cash accounting is the foundation upon which we have built our businesses, allowing us to simply and

accurately report our income and expenses, and to manage our cash flows, for decades. It is a simple and basic method of accounting - we pay taxes on the cash coming in the door, and we deduct expenses when the cash goes out the door. No gimmicks, no spin, no game playing - cash accounting is the very essence of the fairness and simplicity that is on everyone's wish list for tax reform.

Some recent tax reform proposals would require many of our businesses to switch to the accrual method of accounting, not for any policy reason or to combat abuse, but rather for the sole purpose of raising revenues for tax reform. Forcing such a switch would be an effective tax increase on the thousands upon thousands of individual owners who generate local jobs and are integral to the vitality of local economies throughout our nation. It would also increase our recordkeeping and compliance costs due to the greater complexity of the accrual method. Because many of our businesses would have to borrow money to bridge the cash flow gap created by having to pay taxes on money we have not yet collected, we may incur an additional cost with interest expense, a cost that would be exacerbated if interest expense is no longer deductible, as proposed under the House Republicans' Better Way blueprint ("the blueprint"). Some businesses may not be able to borrow the necessary funds to bridge the gap, requiring them to terminate operations with a concomitant loss of jobs and a harmful ripple effect on the surrounding economy.

Tax Reform Proposals and Cash Accounting

The blueprint moves toward a cash flow, destination-based consumption tax. The cash flow nature of the proposal suggests that the cash method of accounting would be integral and entirely consistent with the blueprint since it taxes "cash-in" and allows deductions for "cash-out," including full expensing of capital expenditures. While we understand that they are different proposals, the "ABC Act" (H.R. 4377), a cash flow plan introduced by Rep. Devin Nunes (R-CA) in the 114th Congress, *required* all businesses to use the cash method. However, the blueprint does not provide details regarding the use of the cash method, including whether all businesses would be required to use it, whether businesses currently allowed to use the cash method would continue to be allowed to do so, whether a hybrid method of cash and accrual accounting would apply, or some other standard would be imposed.

President Trump's tax reform plan is not a cash flow plan and takes a more traditional income tax-based approach, yet the principles articulated in the Administration's plan are entirely consistent with the continued availability of the cash method of accounting. Growing the economy, simplification, and tax relief are exemplified by the cash method of accounting. Requiring businesses that have operated using the cash method since their inception to suddenly pay tax on money they have not yet collected, and may never collect, is an effective tax increase, and will have a contraction effect on the economy as funds are diverted from investment in the business to pay taxes on money they have not received or as businesses close because of insufficient cash flow and inability to borrow. It is important to note that cash accounting is not a "tax break for special interests;" it is a simple, well-established and long-authorized way of reporting income and expenses used by hundreds of thousands of family-owned farms, ranches, businesses, and Main Street service providers that are the backbone of any community.

Several recent tax reform proposals, including Senator John Thune's (R-SD) S. 1144, the "Investment in New Ventures and Economic Success Today Act of 2017," would expand the use of cash accounting to allow all businesses under a certain income threshold, including those businesses with inventories, to use cash accounting. Such proposals aim to simplify and reduce recordkeeping burdens and costs for small businesses, while still accurately reporting income and expenses. A few of these proposals (not S. 1144) would pay for this expansion by forcing all other businesses currently using cash accounting to switch to accrual accounting. We do not oppose expanding the allowable use of cash accounting, but it is unfair and inconsistent with the goals of tax reform to pay for good policy with bad policy that has no other justification than raising revenues. When cash accounting makes sense for a particular type of business, the size of the business should make no difference. Further, there have been no allegations that the businesses currently using cash accounting are abusing the method, inaccurately reporting income and expenses, or otherwise taking positions inconsistent with good tax policy.

Tax reform discussions seem to be trending toward faster cost recovery than under current law. For example, the blueprint allows for full expensing of capital investment, Senator Thune's bill makes bonus depreciation permanent, and comments from Administration officials suggest that the President and his team prefer faster write-offs of capital assets. Such policies benefit capital intensive businesses. However, service businesses by their very nature are not capital intensive, so it would be unfair to allow faster cost recovery for some businesses while imposing an effective tax increase and substantial new administrative burdens on pass-through service providers - who will not benefit from more generous expensing or depreciation rules - by taking away the use of cash accounting.

Other Implications of Limiting Cash Accounting

In addition to the policy implications, there are many practical reasons why the cash method of accounting is the best method to accurately report income and expenses for farmers, ranchers, and pass-through service providers:

The accrual method would severely impair cash flow. Businesses could be forced into debt to finance their taxes, including accelerated estimated tax payments, on money we may never receive. Many cash businesses operate on small profit margins, so accelerating the recognition of income could be the difference between being liquid and illiquid, and succeeding or failing (with the resulting loss of jobs).

Loss of cash accounting will make it harder for farmers to stay in business. For farmers and ranchers, cash accounting is crucial due to the number and enormity of up-front costs and the uncertainty of crop yields and market prices. A heavy rainfall, early freeze, or sustained drought can devastate an agricultural community. Farmers and ranchers need the predictability, flexibility and simplicity of cash accounting to match income with expenses in order to handle their tax burden that otherwise could fluctuate greatly from one year to the next. Cash accounting requires no amended returns to even out the fluctuations in annual revenues that are inherent in farming and ranching.

Immutable factors outside the control of businesses make it difficult to determine income. Many cash businesses have contracts with the government, which is known for long delays in making payments that already stretch their working capital. Billings to insurance companies and government agencies for medical services may be subject to new billing codes or be disputed or discounted. Service recipients, many of whom are private individuals, may decide to pay only in part or not at all, or force the provider into protracted collection. Structured settlements and alternative fee arrangements can result in substantial delays in collections, sometimes over several years; therefore, taxes owed in the year a matter is resolved could potentially exceed the cash actually collected.

Recordkeeping burdens, including cost, staff time, and complexity, would escalate under accrual accounting. Cash accounting is simple - cash in/cash out. Accrual accounting is much more complex, requiring sophisticated analyses of when the right to collect income or to pay expenses is fixed and determinable, as well as the amounts involved. In order to comply with the more complex rules, businesses currently handling their own books and records may feel like they have no other choice than to hire outside help or incur the additional cost of buying sophisticated software.

Accrual accounting could have a social cost. Farmers, ranchers, and service providers routinely donate their products and services to underserved and underprivileged individuals and families. An effective tax increase and increased administrative costs resulting from the use of accrual accounting could impede the ability of these businesses to provide such benefits to those in need in their local communities.

Conclusions

The ability of a business to use cash accounting should not be precluded based on the size of the business or the amount of its gross receipts. Whether large or small, a business can have small profit margins, rely on slow-paying government contracts, generate business through deferred fee structures or be wiped out through the vagaries of the weather. Cash diverted toward interest expense, taxes, and higher recordkeeping costs is capital unavailable for use in the actual business, including paying wages, buying capital assets, or investing in growth.

Proposals to limit the use of cash accounting are counterproductive to the already agreed-upon principles of tax reform, which focus on strengthening our economy, fostering job growth, enhancing U.S. competitiveness, and promoting fairness and simplicity in the tax code. Accrual accounting does not make the system simpler, but more complex. Increasing the debt load of American businesses runs contrary to the goal of moving toward equity financing instead of debt financing and will raise the cost of capital, creating a drag on economic growth and job creation. Putting U.S. businesses in a weaker position will further disadvantage them in comparison to foreign competitors. It is simply unfair to ask the individual owners of pass-through businesses to shoulder the financial burden for tax reform by forcing them to pay taxes on income they have not yet collected where such changes are likely to leave them in a substantially worse position than when they started.

As discussions on tax reform continue, the undersigned respectfully request that you take our concerns into consideration and not limit our ability to use cash accounting. We would be happy to discuss our concerns in further detail. Please feel free to contact Mary Baker (mary.baker@klgates.com) or any of the signatories for additional information.

Thank you for your consideration of this important matter.

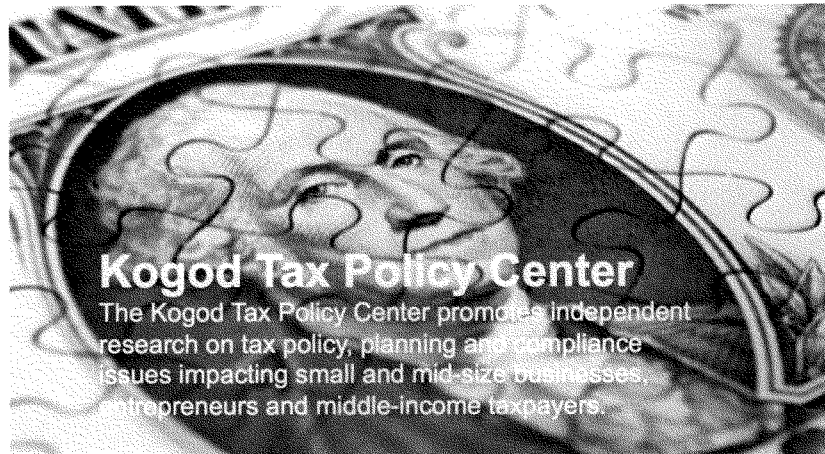
Sincerely,¹

Americans for Tax Reform
 American Council of Engineering Companies
 American Farm Bureau Federation
 American Institute of Certified Public Accountants
 American Medical Association
 The American Institute of Architects
 The National Creditors Bar Association
 Akin Gump Strauss Hauer & Feld LLP
 Baker Donelson
 Debevoise & Plimpton LLP
 Dorsey & Whitney LLP
 Foley & Lardner LLP
 Jackson Walker L.L.P.
 K&L Gates LLP
 Kilpatrick Townsend & Stockton LLP
 Lewis Roca Rothgerber Christie LLP
 Littler Mendelson P.C.
 Miles & Stockbridge P.C.
 Mitchell Silberberg & Knupp LLP
 Morrison & Foerster LLP
 Nelson Mullins Riley & Scarborough LLP
 Ogletree, Deakins, Nash, Smoak & Stewart, P.C.
 Perkins Coie LLP
 Quarles & Brady LLP
 Rubin and Rudman LLP
 Squire Patton Boggs (US) LLP
 Steptoe & Johnson LLP
 White & Case LLP

¹ Although not a signatory to this letter, the American Bar Association (ABA) is working closely with the Coalition and has expressed similar concerns regarding proposals to limit the ability of personal service businesses to use cash accounting. The ABA's most recent letters to the House Ways & Means and Senate Finance Committees are available [here](#) and [here](#).



KOGOD SCHOOL *of* BUSINESS
AMERICAN UNIVERSITY • WASHINGTON, DC



U.S. Senate Committee on Small Business and
Entrepreneurship

Tax Reform: Removing Barriers for Small Business Growth

Statement for the Record

Professor Caroline Bruckner, Executive-in-Residence, Accounting and Taxation and
Managing Director, Kogod Tax Policy Center, Kogod School of Business, American
University.

June 28, 2017

twitter: @carobruckner • cbruck@american.edu • (202) 885-3258

Members of the U.S. Senate Committee on Small Business and Entrepreneurship (the “Committee”) and staff, my name is Caroline Bruckner and I am a tax professor at American University’s Kogod School of Business. I am also the Managing Director of American University’s Kogod Tax Policy Center (KTPC), which conducts nonpartisan policy research on tax and compliance issues specific to small businesses and entrepreneurs. At the KTPC, we applaud the Committee’s initiative in identifying barriers to small business growth as part of its contribution to the tax reform debate.

This Committee has a long history, dating back to its days as a select Senate committee, of working on behalf of America’s small businesses on tax issues. Beginning in 1953, this Committee prepared a comprehensive survey of the impact of federal taxes on small businesses, culminating in a report to the Senate with key recommendations. Since then, this Committee has held at least 40 hearings over the years on tax-related concerns of small businesses. As Congress moves forward with tax reform, this Committee will continue to play a vital role in informing Congress and its tax-writing committees on tax and compliance challenges facing small businesses under the current system, however, with respect to women-owned firms, there is significantly more work to be done.

Specifically, our latest research, *Billion Dollar Blind Spot – How the U.S. Tax Code’s Small Business Tax Expenditures Impact Women Business Owners*, which we released on June 12, 2017, identifies a number of barriers to small business growth that impact women-owned firms, the overwhelming majority of which are small businesses. Moreover, our report assesses how the U.S. tax code’s more than \$255 billion of tax expenditures targeted to help small businesses grow and access capital impact women-owned firms and makes the following findings.

- While women-owned firms have increased to now total more than 11 million (or 38% of all U.S. firms), the majority of women business owners are small businesses operating in service industries and they continue to have challenges growing their receipts and accessing capital.
- At the same time, three of the four small business tax expenditures we assessed are so limited in design that they either (i) explicitly exclude service firms, and by extension, the majority of women-owned firms; or (ii) could effectively bypass women-owned firms who are not incorporated or who are service firms with few capital-intensive equipment investments altogether.
- Our survey data of 515 experienced, engaged women business owners corroborates these findings, and nevertheless suggests that when women-owned firms can take advantage of tax breaks, they do. However, neither Congress nor Treasury or IRS or SBA has ever measured how the tax code impacts women business owners.
- For example, we identified only three women business owners who had ever used Internal Revenue Code Section 1202 - a \$6 billion tax break - to raise capital for their

firms. While we expect that more than three women-owned firms have used this provision since 1993, we don't have publicly-available taxpayer data to prove it. This example highlights why we need tax research on women business owners. Similarly, our survey found that women business owners use Section 179 at significantly lower rates than existing government research finds for businesses generally. This tax break is one of the most expensive (it will cost \$248 billion from 2016-2020), and yet we don't have any research on how it benefits women business owners.

- Our findings raise questions as to (i) whether the U.S. tax code's small business tax expenditures are operating as Congress intended for these small businesses; and (ii) whether the cost of these expenditures has been accounted for in terms of their uptake by women-owned firms.

In answering these questions impacting millions of women business owners, we found that Congress and stakeholders have a billion dollar blind spot when it comes to understanding how effective small business tax expenditures are with respect to women-owned firms. This blind spot indicates Congress does not have data or research to make evidence-based tax policy decisions with respect to these small businesses. Ultimately, we recommend the following strategies for this Committee to employ to develop necessary research on these issues including:

1. Requesting the Congressional tax-writing committees hold joint hearings together with this Committee on the small business tax issues identified in our report;
2. Requesting the Joint Committee on Taxation develop estimates on how small business expenditures impact women-owned firms;
3. Requesting the federal Commission on Evidence-Based Policymaking develop strategies for developing the data we need to measure these expenditures in terms of women-business owners; and
4. Requesting the nomination and confirmation of a new Director of the Census Bureau.

Congress, and specifically this Committee, has demonstrated time and again its commitment to alleviating the tax burdens faced by small businesses. So much so, that under current law, taxpayers will forego more than \$255 billion from 2016 to 2020 just on the four small business tax expenditures assessed in our report. And yet there has been no formal accounting as to whether and how these expenditures impact or are distributed to or among women-owned firms—99% of which are small businesses, according to SBA's Office of Advocacy's latest report on women-owned firms. As a result, Congress doesn't know whether the money it has spent trying to help smaller firms access capital and grow has been well spent with respect to women-owned firms. The absence of research on these issues is contrary to recent Congressional efforts to engage in evidenced-based policy making going forward and means Congress does not have adequate data to understand the barriers to growth impacting more than 11 million small businesses. This Committee can and should immediately work to develop the needed research to understand the tax barriers facing these small businesses.



June 14, 2017

The Honorable James Risch
Chairman
Committee on Small Business and
Entrepreneurship
United States Senate
Washington, DC 20510

The Honorable Jeanne Shaheen
Ranking Member
Committee on Small Business and
Entrepreneurship
United States Senate
Washington, DC 20510

Dear Chairman Risch and Ranking Member Shaheen:

The Small Business Investor Alliance (SBIA) is the leading association of private funds investing in domestic small business. SBIA's members provide capital to small businesses to help them grow from small businesses into medium-sized businesses. These growing small businesses are the basis for the nation's economic and job growth. We applaud your support of small businesses by holding this hearing on "Tax Reform: Removing Barriers to Small Business Growth." The United States needs a tax code that promotes small businesses and growth—not the current one that is impossibly complicated and slows growth.

The SBIA supports robust, pro-growth tax reforms. There is no question the current tax code needs major simplification and reform. There are many good and promising reforms that are being debated and discussed: lowering rates, simplifying the code, treating pass through entities fairly, among others. While we will not comment on each proposal, there is one change that is being discussed that could hurt smaller businesses that are not able to readily access liquid equity markets—the removal of the deductibility of interest expense.

Small businesses employ different capital strategies to finance growth and SBIA's funds support many of them, such as equity, debt, unitranche, and debt with equity features. Smaller businesses regularly rely on debt to finance their operations, to grow, and to create jobs. Debt capital is a fundamental and healthy part of many businesses' capital structure. Growing small businesses need debt capital to finance scaling up and to maintain greater internal control of their business. Without debt, many small businesses would not be able to grow.

Since the advent of the income tax, interest expense has been recognized as a normal and fully deductible expense. Far from being a special interest carveout, the ability to deduct the interest from loans is a universal bedrock business practice. Eliminating the deductibility of interest would have significant adverse effects on how growing businesses finance their operations. Debt is simply the most accessible form of capital for small and medium-sized businesses. Removing interest deductibility will only make it more expensive for these growing businesses to access their primary form of external growth capital. It is important to note that in many cases, small and medium-sized businesses do not even have access to liquid equity markets, so this change would make more expensive their only choice in accessing external growth capital. Moreover, any changes to deductibility of interest would penalize smaller, more

dynamic companies that are reliant upon external financing to manage cash flow, innovate, expand, and create jobs.

SBIA strongly supports reforming and rationalizing the tax code to support domestic investment and growth. All reforms should promote growth and investment and not punish American businesses, particularly small and medium-sized businesses, by limiting interest deductibility. We ask that this committee keep a spotlight on the impact of all aspects of tax reform on small businesses as it works its way through the process.

We appreciate your support of small business and your consideration of these comments.

Sincerely,

A handwritten signature in dark ink, appearing to read "Brett Palmer", is written above the typed name.

Brett Palmer
President
Small Business Investor Alliance

cc: Members of the Committee on Small Business and Entrepreneurship

June 28, 2017

The Honorable Jim Risch, Chairman
Senate Committee on Small Business and Entrepreneurship
428A Russell Senate Office Building
Washington, DC 20510

The Honorable Jeanne Shaheen, Ranking Member
Senate Committee on Small Business and Entrepreneurship
428A Russell Senate Office Building
Washington, DC 20510

Re: Hearing on Tax Reform: Removing Barriers to Small Business Growth

Dear Chairman Risch and Ranking Member Shaheen:

We commend the Senate Small Business and Entrepreneurship Committee for your recent hearing regarding tax reform and the removal of barriers to small business growth, and want to participate by offering comments on several items of particular interest to agricultural producers and rural small business owners.

The following letters were originally submitted for the record to the House Ways and Means Committee May 18, 2017 hearing on how tax reform will grow our economy and create jobs across America. While it is not our intent to offer a comprehensive statement on tax reform, we believe that the views of these organizations on the unique circumstances of small businesses that serve rural communities and the unique business structures and diversity of farms and ranches would be of interest to your Committee in considering small business tax reform issues.

Thank you for your time and attention to this matter.

Sincerely,

Danielle Beck
Director of Government Affairs, National Cattlemen's Beef Association
On behalf of the Tax Aggie Coalition

June 1, 2017

The Honorable Kevin Brady, Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal, Ranking Member
House Committee on Ways & Means
1139E Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Neal:

On behalf of our nation's family farmers and ranchers, we come together now to ask your support for including permanent repeal of the estate tax in any tax reform legislation moving through Congress this year. In addition, we ask your help to make sure that the benefits of repeal are not eroded by the elimination of or restrictions to the use of the stepped-up basis.

Family farmers and ranchers are not only the caretakers of our nation's rural lands but they are also small businesses. The estate tax is especially damaging to agriculture because we are a land-based, capital-intensive industry with few options for paying estate taxes when they come due. Unfortunately, all too often at the time of death, farming and ranching families are forced to sell off land, farm equipment, parts of the operation or take out loans to pay off tax liabilities and attorney's fees.

As you know, the American Taxpayer Relief Act of 2012 (ATRA) permanently extended the estate tax exemption level to \$5 million per person/\$10 million per couple indexed for inflation, and maintained stepped up basis. While we are grateful for the relief provided by the ATRA, the current state of our economy, combined with the uncertain nature of our business has left many agricultural producers guessing about their ability to plan for estate tax liabilities and unable to make prudent business decisions. Until the estate tax is fully repealed it will continue to threaten the economic viability of family farms and ranches, as well as the rural communities and businesses that agriculture supports.

In addition to full repeal of the estate tax, we believe it is equally as important for Congress to preserve policies which help keep farm businesses in-tact and families in agriculture. As such, tax reform must maintain stepped-up basis, which limits the amount of property value appreciation that is subject to capital gains taxes if the inherited assets are sold. Because farmland typically is held by one owner for several decades, setting the basis on the value of the farm on the date of the owner's death under stepped-up basis is an important tax provision for surviving family members.

U.S. farmers and ranchers understand and appreciate the role of taxes in maintaining and improving our nation; however, the most effective tax code is a fair one. For this reason, we respectfully request that any tax reform legislation considered in Congress will strengthen the business climate for farm and ranch families while ensuring agricultural businesses can be passed to future generations.

Thank you for your continued efforts in support of our nation's agricultural producers. We look forward to working with you on this very important issue.

Respectfully,

Agricultural & Food Transporters Conference
Agricultural Retailers Association
American Farm Bureau Federation
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
Livestock Marketing Association
National Association of State Departments of Agriculture
National Barley Growers Association
National Cattlemen's Beef Association
National Cotton Council
National Council of Farmer Cooperatives
National Milk Producers Federation
National Peach Council
National Pork Producers Council
National Potato Council
National Renderers Association
National Sorghum Producers
National Turkey Federation
Panhandle Peanut Growers Association
South East Dairy Farmers Association
Southwest Council of Agribusiness
U.S. Apple Association
U.S. Canola Association
U.S. Rice Producers Association
U.S. Sweet Potato Council
United Egg Producers
United Fresh Produce Association
USA Rice Federation
Western Growers
Western Peanut Growers Association
Western United Dairymen

June 1, 2017

The Honorable Kevin Brady, Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal, Ranking Member
House Committee on Ways & Means
1139E Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Neal:

On behalf of our nation's family farmers and ranchers, the undersigned groups would like to thank you for your efforts to reform the U.S. tax code in a meaningful way for individuals, corporations, and small businesses alike, including the 3.2 million farmers who generate food, fuel, and fiber for Americans and people around the world. With that in mind, we write today to express our concerns regarding the House Committee on Ways and Means blueprint proposal to eliminate the deduction for interest payments as a business expense.

Agricultural production is capital intensive. While financing requirements will vary among the different commodities, the majority of family-owned farming operations are heavily reliant on credit. Even for everyday business, agricultural producers utilize credit in the form of operating and inventory loans. According to the United States Department of Agriculture (USDA), net farm income in 2017 is forecast to decline for the fourth consecutive year by 8.7 percent to \$62.3 billion. In a weak farm economy, income is restricted to cover family farmers' living expenses and the repayment of debt. During tough times, producers are often forced to take on substantial annual interest expense. Interest paid on these loans should be deductible because interest is, and has historically been, considered a legitimate business expense.

In addition, family farmers continue to grow their operations in order to remain profitable. Equipment and land acquisition necessary for long-term expansion is only possible through financing. USDA predicts that in 2017, farm real estate debt will reach a historic high of \$240.7 billion, a 5.2 percent increase from 2016. Eliminating the interest deduction will place further financial stress on an already debt-burdened industry, and prevent producers from staying profitable in challenging economic times.

Finally, the need for debt financing is particularly important for the next generation of agricultural producers. Less than 2 percent of the U.S. population is directly employed in agriculture. Consistent with a 30-year trend, the average age of principal farm operators is 58, making farmers and ranchers among the oldest workers in the nation. As older producers exit the workforce, financing will be critically important for new and beginning farmers and ranchers looking to establish businesses. Eliminating interest deductions creates a significant barrier for the next generation.

As Congress works to enact comprehensive tax legislation, the positive reforms made should not be undermined by negative, unintended consequences as a result of eliminating the business interest deduction for agricultural entities. It is our hope that future legislative proposals do not ignore this important sector of the nation's economy, and that they will consider the unique utilization and importance of credit management across the entire agriculture sector.

Thank you for your continued efforts in support of our nation's agricultural producers. We look forward to working with you on this important issue.

Respectfully,

Agricultural & Food Transporters Conference
Agricultural Retailers Association
American Farm Bureau Federation
American Mushroom Institute
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
California Association of Winegrape Growers
Cobank
Farm Credit Council
National Barley Growers Association
National Cattlemen's Beef Association
National Corn Growers Association
National Cotton Council
National Council of Farmer Cooperatives
National Peach Council
National Pork Producers Council
National Potato Council
National Renderers Association
National Sorghum Producers
Panhandle Peanut Growers Association
Southwest Council of Agribusiness
South East Dairy Farmers Association
United Egg Producers
United Fresh Produce Association
U.S. Apple Association
U.S. Canola Association
U.S. Rice Producers Association
U.S. Sweet Potato Council
USA Rice Federation
Western Growers
Western Peanut Growers Association

June 1, 2017

The Honorable Kevin Brady, Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal, Ranking Member
House Committee on Ways & Means
1139E Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Neal:

America's farmers and ranchers rely on various tax code provisions to survive the constant financial and economic ups and downs that come with farming and ranching. The undersigned agricultural groups ask for your robust support of these critical provisions that ensure their long-term financial well-being.

Cash accounting allows farmers and ranchers to improve cash flow by recognizing income when it is received and recording expenses when they are paid. This provides the flexibility needed to plan for future business investments and in many cases provides guaranteed availability of agricultural inputs. Loss of cash accounting would create a situation where a farmer or rancher would have to pay taxes on income before receiving payment for sold commodities.

Like-kind exchanges help farmers and ranchers operate more efficient businesses by allowing them to defer taxes when they sell land, buildings, equipment, and livestock or purchase replacement property. Without like-kind exchanges some farmers and ranchers would need to incur debt in order to continue their farm or ranch businesses or, worse yet, delay mandatory improvements to maintain the financial viability of their farm or ranch business.

Farm and ranch businesses operate in a constant world of uncertainty with ongoing expenses and a fluctuating income. Income averaging, which permits revenue to be averaged over three years, allows farmers and ranchers to level out their tax liability and produces a more dependable and consistent revenue stream that aids financial management.

As Congress moves forward with its tax reform proposals and debate, we urge your support for these important tax provisions. Thank you for your continued efforts to support our nation's farmers and ranchers whose work allows us to enjoy the safest, most abundant and affordable food supply in the world. We look forward to working with you on these important issues.

Sincerely,

Agricultural & Food Transporters Conference
Agricultural Retailers Association
American Mushroom Institute

American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
California Association of Winegrape Growers
Cobank
National Barley Growers Association
National Cattlemen's Beef Association
National Corn Growers Association
National Cotton Council
National Council of Farmer Cooperatives
National Peach Council
National Pork Producers Council
National Potato Council
National Renderers Association
National Sorghum Producers
Panhandle Peanut Growers Association
Southwest Council of Agribusiness
South East Dairy Farmers Association
United Egg Producers
United Fresh Produce Association
U.S. Apple Association
U.S. Canola Association
U.S. Rice Producers Association
U.S. Sweet Potato Council
USA Rice Federation
Western Growers
Western Peanut Growers Association
Western United Dairymen

June 1, 2017

The Honorable Kevin Brady, Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal, Ranking Member
House Committee on Ways & Means
1139E Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Neal:

On behalf of the nation's farmers and ranchers, the organizations listed below are writing today regarding one of our priorities for federal tax reform: a reduction in capital gains taxes.

Capital gains taxes have a significant impact on production agriculture and producers' long-term investments in land, breeding livestock and buildings. We believe a reduction of the tax rate on capital gains and assets indexed for inflation would enable producers to better respond to new market opportunities and facilitate the transfer of land to young and beginning farmers.

Taxation for capital gains upon the sale of farm assets creates a number of problems, particularly when an asset sale causes a sharp transitory spike in income that pushes farmers and ranchers into a higher than usual tax bracket. USDA has found that 40 percent of family farms have reported some capital gains or losses, compared to 13.6 percent for an average individual taxpayer.

Another problem is the "lock-in" effect where the higher the capital gains tax rate, the greater disincentive to sell property or alternatively to raise the asking price. In today's agriculture economy, starting a farm or ranch requires a large investment due to the capital-intensive nature of agri-business, with land and buildings typically accounting for 79 percent of farm and ranch assets. Given the barrier created by the capital gains tax, landowners are discouraged to sell, making it even more difficult for new farmers to acquire land and agriculture producers who want to purchase land to expand their business to include a son or daughter. This lose-lose scenario also interferes with capital that would otherwise spur new and more profitable investments.

At a time of heightened financial stress in our agriculture economy, it is more critical now for farmers and ranchers to have the flexibility to change their operations to respond to consumer demand in an increasingly dynamic market. Because of the capital gains taxes imposed when buildings, breeding livestock, farmland and agricultural conservation easements are sold, the higher the tax rate the more difficult it is for producers to cast off unneeded assets to generate revenue, upgrade their operations and adapt to changing markets.

As you continue your work on legislation to reform the tax code, we urge you to carefully consider our recommendations to address these concerns regarding the inadequacies and inefficiencies of current

capital gains tax provisions. We acknowledge the extremely complex task of crafting legislation to adopt comprehensive tax reform and appreciate your support of America's farmers and ranchers.

Sincerely,

Agricultural & Food Transporters Conference
 Agricultural Retailers Association
 American Farm Bureau Federation
 American Farmland Trust
 American Mushroom Institute
 American Sheep Industry Association
 American Soybean Association
 American Sugarbeet Growers Association
 California Association of Winegrape Growers
 Cobank
 National Barley Growers Association
 National Cattlemen's Beef Association
 National Corn Growers Association
 National Cotton Council
 National Council of Farmer Cooperatives
 National Milk Producers Federation
 National Peach Council
 National Pork Producers Council
 National Potato Council
 National Renderers Association
 National Sorghum Producers
 Panhandle Peanut Growers Association
 Southwest Council of Agribusiness
 South East Dairy Farmers Association
 United Egg Producers
 United Fresh Produce Association
 U.S. Apple Association
 U.S. Canola Association
 U.S. Rice Producers Association
 U.S. Sweet Potato Council
 USA Rice Federation
 Western Growers
 Western Peanut Growers Association
 Western United Dairywomen

June 1, 2017

The Honorable Kevin Brady, Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal, Ranking Member
House Committee on Ways & Means
1139E Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Neal:

On behalf of our nation's family farmers and ranchers, the undersigned agricultural producer groups urge your support for maintaining the Section 199 deduction for domestic production activities income as part of any tax reform plan.

The Section 199 deduction was enacted as part of the American Jobs Creation Act of 2004 as a domestic production and jobs creation measure. The deduction applies to proceeds from agricultural or horticultural products that are manufactured, produced, grown, or extracted in the United States, including dairy, grains, fruits, nuts, soybeans, sugar beets, oil and gas refining, and livestock. Farmer-owned cooperatives are able to apply their wages to the calculation of the deduction, and then choose to pass it through to their farmer members or keep it at the cooperative level, making it extremely beneficial to both.

The Section 199 deduction is limited to the lesser of 9 percent of adjusted gross income or domestic production activities income or 50 percent of wages paid to produce such income. Reducing or eliminating the domestic activities deduction would result in a significant increase in taxable income for all farms that currently employ non-family labor. On the other hand, the benefit of the deduction would increase if agricultural producers were able to count non-cash wages paid, such as crop share payments of commodities.

The Section 199 deduction serves as both a domestic production and jobs creation incentive and has provided needed relief for producers in times when prices are depressed. Section 199 benefits are returned to the economy through job creation, increased spending on agricultural production, and increased spending in rural communities.

Thank you for your continued efforts in support of our nation's agricultural producers. We look forward to working with you on this important issue.

Respectfully,

Agricultural & Food Transporters Conference
Agricultural Retailers Association

American Farm Bureau Federation
American Mushroom Institute
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
California Association of Winegrape Growers
Cobank
National Barley Growers Association
National Cattlemen's Beef Association
National Corn Growers Association
National Cotton Council
National Council of Farmer Cooperatives
National Milk Producers Federation
National Peach Council
National Pork Producers Council
National Potato Council
National Renderers Association
National Sorghum Producers
Panhandle Peanut Growers Association
Southwest Council of Agribusiness
South East Dairy Farmers Association
United Egg Producers
United Fresh Produce Association
U.S. Canola Association
U.S. Rice Producers Association
U.S. Sweet Potato Council
USA Rice Federation
Western Growers
Western Peanut Growers Association
Western United Dairymen

June 1, 2017

The Honorable Kevin Brady, Chairman
House Committee on Ways & Means
1102 Longworth House Office Building
Washington, DC 20515

The Honorable Richard Neal, Ranking Member
House Committee on Ways & Means
1139E Longworth House Office Building
Washington, DC 20515

Dear Chairman Brady and Ranking Member Neal:

The undersigned agricultural organizations urge your support for several tax provisions related to renewable energy and environmental mitigation as part of any broader tax reform plan taken up by Congress.

U.S. farmers and ranchers and the companies that process agricultural products provide food, feed, fiber and fuel for our nation and the world. Like all businesses, we must continue to innovate, establish new markets, and improve efficiency to remain viable and competitive in today's global market. Whether it is to help reduce regulatory compliance costs or to incentivize renewable energy and conservation benefits, there are a number of tax provisions that have been implemented or proposed for agricultural products and practices.

In recent years, regulators have applied increasing pressure on the agriculture sector to reduce output of nutrients like nitrogen and phosphorus to improve water quality in various watersheds around the country, from the Chesapeake Bay to the Great Lakes region. To help solve this problem, tax-writers in Congress have introduced bipartisan legislation to spur adoption and help cover the upfront capital costs of nutrient recovery technologies, as well as biogas systems that mitigate the environmental impacts of farming by transforming manure into stable fertilizer for crops, bedding for cows, and fuel and electricity for farms and nearby homes.

Tax incentives, such as the biodiesel tax credit, have also existed to support renewable energy and fuel derived from agricultural feedstocks, including animal fats. These renewable energy sources help diversify our fuel supply, establish new markets and add value to farm products, create jobs, and boost economic development, particularly in rural America. U.S. biodiesel producers have unused production capacity that stands ready to be utilized. Putting that capacity to work will encourage further market growth for agricultural products and create thousands of new jobs and billions of dollars in economic activity.

As you move forward with tax proposals, U.S. farmers and ranchers support the inclusion of these tax provisions that help our businesses meet regulatory requirements, provide conservation benefits and incentivize renewable energy production. Thank you for your continued efforts in support of our

nation's farmers and ranchers. We look forward to working with you as the process on tax reform continues.

Respectfully,

Agricultural & Food Transporters Conference
Agricultural Retailers Association
American Farm Bureau Federation
American Mushroom Institute
American Sheep Industry Association
American Soybean Association
American Sugarbeet Growers Association
Cobank
National Barley Growers Association
National Corn Growers Association
National Council of Farmer Cooperatives
National Milk Producers Federation
National Peach Council
National Pork Producers Council
National Renderers Association
Panhandle Peanut Growers Association
Southwest Council of Agribusiness
South East Dairy Farmers Association
United Egg Producers
United Fresh Produce Association
U.S. Canola Association
U.S. Rice Producers Association
U.S. Sweet Potato Council
USA Rice Federation
Western Growers
Western Peanut Growers Association
Western United Dairymen

June 28, 2017

The Honorable James Risch
Chairman
Senate Committee on Small Business
& Entrepreneurship
428A Russell Senate Office Building
Washington, D.C. 20510

The Honorable Jeanne Shaheen
Ranking Member
Senate Committee on Small Business
& Entrepreneurship
428A Russell Senate Office Building
Washington, D.C. 20510

Dear Chairman Risch and Ranking Member Shaheen:

In connection with the Senate Committee on Small Business & Entrepreneurship's June 14, 2017 hearing on *Tax Reform: Removing Barriers to Small Business Growth*, we are submitting as a statement for the record the attached letter urging you to preserve the current availability of like-kind exchange treatment as part of any business tax reform. Thank you for your consideration and your leadership on these important issues.

Sincerely,

The Like-Kind Exchange Stakeholder Coalition

THE LIKE-KIND EXCHANGE STAKEHOLDER COALITION

November 29, 2016

Mr. Jim Carter
Tax Policy Lead
Presidential Transition
1800 F Street NW
Washington, DC 20006

Dear Mr. Carter:

As you consider ways to create jobs, grow the economy, and raise wages through tax reform, we strongly urge that current law be retained regarding like-kind exchanges under section 1031 of the Internal Revenue Code (“Code”). We further encourage retention of the current unlimited amount of gain deferral.

Like-kind exchanges are integral to the efficient operation and ongoing vitality of thousands of American businesses, which in turn strengthen the U.S. economy and create jobs. Like-kind exchanges allow taxpayers to exchange their property for more productive like-kind property, to diversify or consolidate holdings, and to transition to meet changing business needs. Specifically, section 1031 provides that taxpayers do not immediately recognize a gain or loss when they exchange assets for “like-kind” property that will be used in their trade or business. They do immediately recognize gain, however, to the extent that cash or other “boot” is received. Importantly, like-kind exchanges are similar to other non-recognition and tax deferral provisions in the Code because they result in no change to the economic position of the taxpayer.

Since 1921, like-kind exchanges have encouraged capital investment in the U.S. by allowing funds to be reinvested back into the enterprise, which is the very reason section 1031 was enacted in the first place. This continuity of investment not only benefits the companies making the like-kind exchanges, but also suppliers, manufacturers, and others facilitating them. Like-kind exchanges ensure both the best use of real estate and a new and used personal property market that significantly benefits start-ups and small businesses. Eliminating like-kind exchanges or restricting their use would have a contraction effect on our economy by increasing the cost of capital, slowing the rate of investment, increasing asset holding periods and reducing transactional activity.

A 2015 macroeconomic analysis by Ernst & Young found that either repeal or limitation of like-kind exchanges could lead to a decline in U.S. GDP of up to \$13.1 billion annually.¹ The Ernst & Young study quantified the benefit of like-kind exchanges to the U.S. economy by recognizing that the exchange transaction is a catalyst for a broad stream of economic activity involving businesses and service providers that are ancillary to the exchange transaction, such as brokers, appraisers, insurers, lenders, contractors, manufacturers, etc. A 2016 report by the Tax

¹ *Economic Impact of Repealing Like-Kind Exchange Rules*, ERNST & YOUNG (March 2015, Revised November 2015), at (iii), available at <http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf>.

Foundation estimated even greater economic contraction – a loss of 0.10% of GDP, equivalent to \$18 billion annually.²

Companies in a wide range of industries, business structures, and sizes rely on the like-kind exchange provision of the Code. These businesses—which include real estate, construction, agricultural, transportation, farm / heavy equipment / vehicle rental, leasing and manufacturing—provide essential products and services to U.S. consumers and are an integral part of our economy.

A microeconomic study by researchers at the University of Florida and Syracuse University, focused on commercial real estate, supports that without like-kind exchanges, businesses and entrepreneurs would have less incentive and ability to make real estate and other capital investments.³ The immediate recognition of a gain upon the disposition of property being replaced would impair cash flow and could make it uneconomical to replace that asset. This study further found that taxpayers engaged in a like-kind exchange make significantly greater investments in replacement property than non-exchanging buyers.

Both studies support that jobs are created through the greater investment, capital expenditures and transactional velocity that are associated with exchange properties. A \$1 million limitation of gain deferral per year, as proposed by the Administration⁴, would be particularly harmful to the economic stream generated by like-kind exchanges of commercial real estate, agricultural land, and vehicle / equipment leasing. These properties and businesses generate substantial gains due to the size and value of the properties or the volume of depreciated assets that are exchanged. A limitation on deferral would have the same negative impacts as repeal of section 1031 on these larger exchanges. Transfers of large shopping centers, office complexes, multifamily properties or hotel properties generate economic activity and taxable revenue for architects, brokers, leasing agents, contractors, decorators, suppliers, attorneys, accountants, title and property / casualty insurers, marketing agents, appraisers, surveyors, lenders, exchange facilitators and more. Similarly, high volume equipment rental and leasing provides jobs for rental and leasing agents, dealers, manufacturers, after-market outfitters, banks, servicing agents, and provides inventories of affordable used assets for small businesses and taxpayers of modest means. Turnover of assets is key to all of this economic activity.

In summary, there is strong economic rationale, supported by recent analytical research, for the like-kind exchange provision's nearly 100-year existence in the Code. Limitation or repeal of section 1031 would deter and, in many cases, prohibit continued and new real estate and capital investment. These adverse effects on the U.S. economy would likely not be offset by lower tax rates. Finally, like-kind exchanges promote uniformly agreed upon tax reform goals such as economic growth, job creation and increased competitiveness.

² *Options for Reforming America's Tax Code*, Tax Foundation (June, 2016) at p79, available at <http://taxfoundation.org/article/options-reforming-americas-tax-code>.

³ David Ling and Milena Petrova, *The Economic Impact of Repealing or Limiting Section 1031 Like-Kind Exchanges in Real Estate* (March 2015, revised June 2015), at 5, available at <http://www.1031taxreform.com/wp-content/uploads/Ling-Petrova-Economic-Impact-of-Repealing-or-Limiting-Section-1031-in-Real-Estate.pdf>.

⁴ *General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals*, at 107, available at <https://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2017.pdf>.

Thank you for your consideration of this important matter.

Sincerely,

Air Conditioning Contractors of America
American Car Rental Association
American Rental Association
American Seniors Housing Association
American Truck Dealers
American Trucking Associations
Associated Equipment Distributors
Associated General Contractors of America
Avis Budget Group, Inc.
Building Owners and Managers Association (BOMA) International
C.R. England, Inc.
Equipment Leasing and Finance Association
Federation of Exchange Accommodators
International Council of Shopping Centers
NAIOP, the Commercial Real Estate Development Association
National Apartment Association
National Association of Home Builders
National Association of Real Estate Investment Trusts
National Association of REALTORS®
National Automobile Dealers Association
National Business Aviation Association
National Multifamily Housing Council
National Ready Mixed Concrete Association
National Stone, Sand and Gravel Association
Truck Renting and Leasing Association